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Commentaries

Tender Offer Defensive Tactics: A Proposal for Reform†

by MARY SIEGEL*

In recent years, corporate management has captured the attention of the public, scholars, journalists, courts, and Congress by employing a variety of creative and effective tactics to defend its corporation from a tender offer. Once content to use tactics that merely deterred or deflected hostile tender offers, target management has now escalated the war against such offers by devising defensive tactics that have been colorfully described as the "Jonestown Defense,"¹ "Pac-Man offers,"² "crown jewel options,"³ and "golden parachute agreements."⁴

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1. H. LAMPERT, *TILL DEATH DO US PART* 65 (1983) (quoting Jay Higgins, an investment banker with Solomon Brothers, who worked for Bendix Corporation during the 1983 Bendix-Martin Marietta takeover battle).

2. In the "Pac-Man" defensive tactic, the target company counters an unwanted tender offer by making its own tender offer for the stock of the would-be acquiror. By making a counter offer, the target company implicitly acknowledges the desirability of a combination between itself and the bidder. The counter offer changes the terms of that combination, particularly determining which corporation will be dominant. The target necessarily waives certain defenses such as antitrust and regulatory claims, but may continue to contest the ultimate management control, terms, and capital structure of the first proposed business combination.

There are two common business justifications for employing the Pac-Man defense. First, the board may conclude that the company should not only remain independent to develop its own businesses, but also acquire the raider because acquisition presents a desirable business opportunity. The second justification commonly advanced is that the company should be sold only at a higher price or on different terms.

3. The "crown-jewel option" involves the grant of an option to purchase a key asset of the target company, commonly referred to as its "crown jewel." The crown jewel option is particularly useful when this asset is the hostile bidder's primary motive for commencing the

Behind the drama lie several fundamental issues of corporate law. Target management, when confronted with a hostile tender offer,⁵ faces a potential conflict of interest concerning whether it can fight the offer and simultaneously satisfy its fiduciary duty of loyalty. Although most courts have found that management can achieve both,⁶ many scholars⁷ and some judges⁸ vehemently disagree. If satisfaction of the fiduciary duty of loyalty and impartial evaluation of the merits of a tender offer are mutually exclusive accomplishments for target management, then legislatures must address whether and how to regulate tender offers in an environment that increasingly presents this dilemma. Despite a variety of proposals by courts and scholars, none has successfully balanced the

takeover. Thus, by granting this option to someone else, the target immediately makes itself unattractive to the hostile bidder. See also *infra* notes 27, 29 & accompanying text.

4. "Golden parachutes" are special employment contracts that protect key executives should control of their company change hands. These contracts frequently provide management with long tenure, as well as the right to large severance benefits and acceleration of benefits. These contracts thus allow executives to bail out from a hostile takeover battle with financial security; hence, the nickname "golden parachute." See, e.g., Morrison, *Those Executive Bailout Deals*, *FORTUNE*, Dec. 13, 1982, at 82, 84 (Mr. Agee, Chief Executive Officer of Bendix Corp., received a \$4 million golden parachute); *Wall St. J.*, Sept. 10, 1982, at 2, col. 2 (Bendix Corp. granted certain key executives right to three year base salary and incentive compensation payments if control were to change).

The justification for these agreements is that management, fortified with the knowledge that they will be financially secure no matter who wins a control battle, will be able to accept or reject a tender offer strictly on the merits. See Moore, *Golden Parachute Agreements Shelter Displaced Executives*, *Legal Times*, Oct. 25, 1982, at 5, col. 1 (golden parachutes are necessary to protect key executives in "an age of corporate cannibalism").

Critics of the golden parachute agreements charge that directors who benefit from these agreements violate their duty of undivided loyalty to the company. See Johnson, *Anti-Takeover Action and Defenses: Business Judgment or Breach of Duty?*, 28 *VILL. L. REV.* 51, 70 (1982) (incentive to inform and protect shareholders might take second place to potential financial windfall). Critics charge that directors utilize corporate funds to protect their position or to ensure large severance payments in the event they lose their job when control changes. Morrison, *supra*, at 83. Critics also argue that these contracts may have the effect of reducing the price per share of the tender offer to reflect the cost of these agreements. Johnson, *supra*, at 70. Furthermore, they may have the effect of discouraging all tender offers, some of which may be in the best interest of the corporation and its shareholders, because a successful bidder may incur large payments to departing target management. Cf. *Federal Sav. & Loan Ins. Corp. v. Bass*, 576 F. Supp. 848, 852-53 (N.D. Ill. 1983) (golden parachutes constituted a breach of the statutory duty of officers to prohibit employment agreements constituting an unsafe or unsound practice).

5. See *infra* note 21 & accompanying text. These defensive tactics indicate that target management has a substantial interest in preserving its salaries and status. The directors' decision to resist a tender offer may be motivated more by a desire to retain control than by concern for the welfare of the shareholders.

6. See *infra* note 22 & accompanying text.

7. See, e.g., *infra* notes 97-98 & accompanying text.

8. See, e.g., *infra* note 81 & accompanying text.

competing interests presented in a tender offer to gain wide acceptance.⁹ Moreover, if regulation is needed, the appropriate agent for regulation, either the states or the federal government, should be identified.

This Commentary reviews and evaluates the current state of the regulation of tender offer defensive tactics, as well as certain existing proposals for reform. The Commentary proposes a modification of existing state corporate statutes to provide a definitive standard for regulating defensive tactics. Part I delineates the current state of both the relevant statutory law and common law. Part II first analyzes the relevant court decisions and concludes that the current judicial regulation of defensive tactics is deficient. Part II then discusses and rejects judicial and scholarly proposals thus far advanced for curing this deficiency. Part III compares the current law governing defensive tactics with the status of the freeze-out mergers in the mid 1970's and draws some lessons for the defensive regulation of tactics from the resolution of the freeze-out issue. Finally, in Part IV the author proposes that defensive tactics be regulated by substituting the current subjective standard for defensive tactics with an objective procedural test at the state level requiring a shareholder vote to authorize any defensive tactic.

The Law Governing Defensive Tactics

The Director's Fiduciary Duty Under the Business Judgment Rule

One possible mechanism to regulate the defensive tactics of target management in a hostile tender offer is the application of the business judgment rule, which shields directors from liability if they fulfill their common law fiduciary duties.¹⁰ Directors may satisfy those duties by acting as prudent business managers, in good faith, and in a manner reasonably calculated to ensure that they operate the corporation for the

9. For criticism of judicial application of the business judgment rule, see *infra* notes 56-67 & accompanying text. For criticism of judicial application of the "fairness" doctrine, see *infra* notes 81-87 & accompanying text. For a critique of the proposal offered by Judge Easterbrook and Professor Fischel, see *infra* notes 92-94 & accompanying text. For a critique of the solution offered by Professor Gilson, see *infra* text accompanying note 104. For a critique of Professor Lowenstein's proposal, see *infra* notes 108-13 & accompanying text.

10. See e.g., *Glassberg v. Boyd*, 35 Del. Ch. 293, 308, 116 A.2d 711, 719 (1955) (holding that presumption of good faith protected directors who were not liable for payment of out-of-state tax subsequently declared unconstitutional); *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 180-81, 237 N.E.2d 776, 781 (1968) (declining to interfere with business judgment of board of directors of baseball team not to schedule night home games); *Hornstein v. Paramount Pictures, Inc.*, 292 N.Y. 468, 471, 55 N.E.2d 740, 741 (1944) (per curiam) (upholding business judgment of directors in paying racketeers in violation of labor relations act).

benefit of its shareholders.¹¹ Fulfillment of their fiduciary duties frees directors from liability for good faith errors in judgment. Furthermore, the business judgment rule protects directors from liability for decisions that, although properly made, produce poor results.

Three traditional justifications for the business judgment rule have been developed. First, the rule allows directors the freedom to formulate effective corporate policy.¹² Second, the rule encourages competent people to become directors by alleviating their fear of personal liability for honest mistakes in judgment.¹³ Third, the rule relieves courts of the burden of second-guessing complex corporate decisions, a task for which courts often lack the necessary expertise, information, and time.¹⁴ The business judgment rule thus articulates the principle that although shareholders have a right to expect their directors to exercise due care and undivided loyalty to the corporation, they cannot expect directors to guarantee the success of their decisions.¹⁵

11. See, e.g., *Litwin v. Allen*, 25 N.Y.S.2d 667 (Sup. Ct. 1940). The director must exercise his management duties honestly and in good faith:

[A] director owes loyalty and allegiance to the company—a loyalty that is undivided and an allegiance that is influenced in action by no consideration other than the welfare of the corporation. Any adverse interest of a director will be subjected to a scrutiny rigid and uncompromising. He may not profit at the expense of his corporation and in conflict with its rights; he may not for personal gain divert unto himself the opportunities which in equity and fairness belong to his corporation. He is required to use his independent judgment. In the discharge of his duties a director must, of course, act honestly and in good faith, but that is not enough. He must also exercise some degree of skill and prudence and diligence.

Id. at 677-78; see also *Conoco Inc. v. Seagram Co.*, 517 F. Supp. 1299, 1303 (S.D.N.Y. 1981) (directors are under a duty to exercise best judgment with respect to any proposal pertaining to corporate affairs); *Berman v. Gerber Prods. Co.*, 454 F. Supp. 1310, 1319 (W.D. Mich. 1978) (directors have an affirmative duty to use best judgment for the corporation); *Bodell v. General Gas & Elec. Corp.*, 15 Del. Ch. 119, 129, 132 A. 442, 446 (1926) ("There is no rule better settled . . . than that directors in their conduct of the corporation stand in the situation of fiduciaries."), *aff'd*, 15 Del. Ch. 420, 140 A. 264 (1927). See generally *Lipton, Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 105 (1979) (directors owe fiduciary duty to shareholders to act as prudent business managers in good faith on reasonable basis of assurance that business operates for benefit of shareholders) [hereinafter cited as *Lipton, Takeover Bids*].

12. See generally *Block & Prussian, The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27, 32 (1981) (rule affords directors broad discretion needed to formulate company policy without fear of judicial second-guessing).

13. See *id.* (quoting *Percy v. Millaudon*, 8 Mart. (n.s.) 68, 78 (La. 1829)).

14. See *Block & Prussian, supra* note 12, at 33 (the most important rationale is to avoid over-burdening the courts); see also *Auerbauch v. Bennett*, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979) (rule is partly grounded in "the prudent recognition that courts are ill-equipped and infrequently called on to evaluate what are and must be essentially business judgments").

15. See *Percy v. Millaudon*, 8 Mart. (n.s.) 68, 78 (La. 1829). In *Percy*, the court stated that "the contrary doctrine [to the rule that directors need only possess ordinary knowledge] seems to us to suppose the possession, and require the exercise of perfect wisdom in fallible

The Problems of Proof in Establishing a Breach of Fiduciary Duty

The business judgment rule presupposes that the directors have fulfilled their fiduciary duties of care and loyalty. The plaintiffs thus bear the burden of establishing that the directors have abused their fiduciary duties by either acting without care or disregarding their duty of loyalty and allowing impermissible personal motives to dominate their decisions.¹⁶

To prove that the directors breached their fiduciary duty of care in the tender offer context, plaintiffs must demonstrate that the directors did not ascertain the relevant facts before reaching their decision.¹⁷ For example, the directors may have failed to consider alternative proposals and competing offers,¹⁸ or they may have neglected to obtain the advice of outside experts, such as lawyers, accountants, and investment bankers.¹⁹ In contrast to the concrete steps that demonstrate whether directors have fulfilled their duty of care, proof that directors have violated

human beings. No man would undertake to render service to another in such severe conditions." *Id.*

16. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271, 296 (7th Cir.) (plaintiff must prove bad faith, self dealing, or fraud to raise inference that impermissible motives predominate board's action), *cert. denied*, 454 U.S. 1092 (1981); *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980) (plaintiff must show directors acted in bad faith, or in furtherance of their own interests or some other improper purposes); *Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980) (business judgment rule places burden on shareholders to show impermissible motives), *cert. denied*, 450 U.S. 999 (1981); *Barnes v. Andrews*, 298 F. 614, 616 (S.D.N.Y. 1924) (burden on plaintiff to show defendant director's fulfillment of fiduciary duties would have prevented loss); *Auerbauch*, 47 N.Y.2d at 630, 393 N.E.2d at 1000, 419 N.Y.S.2d at 926 (plaintiff must prove bad faith or fraud).

17. See, e.g., *Barnes*, 298 F. at 615 (duty of director to keep himself informed); *Kamin v. American Express Co.*, 86 Misc. 2d 809, 813-14, 383 N.Y.S.2d 807, 811 (Sup. Ct.) (board decision upheld where finance committee minutes showed directors had considered various proposed plans), *aff'd*, 54 N.Y.2d 654, 387 N.Y.S.2d 933 (1976).

18. See, e.g., *Thomas v. Kempner*, 398 A.2d 320, 323-24 (Del. Ch. 1979) (directors failed to fulfill duty of due care when they authorized sale of assets while ignoring competing offer at significantly higher price); see also *Kamin*, 86 Misc. 2d at 813-14, 383 N.Y.S.2d at 811 (board decision upheld where minutes of special board meeting showed directors considered various proposed plans).

19. Directors are generally permitted to rely reasonably, and in good faith on experts chosen with due care. See, e.g., *Panter*, 486 F. Supp. at 1194 (directors entitled to rely on outside experts); *Cheff v. Mathes*, 41 Del. Ch. 494, 507, 199 A.2d 548, 556 (1964) (in deciding to repurchase raider's stock, directors properly relied on reports of investment bankers and corporate officers that showed raider had "bad reputation" in the business community and might attempt to liquidate target to obtain quick profit); *Kaplan v. Goldsamt*, 380 A.2d 556, 568 (Del. Ch. 1977) (board properly relied on reports of investment bankers in setting price for stock repurchase). Furthermore, some state corporation laws expressly permit reliance on experts. See, e.g., MODEL BUSINESS CORP. ACT §§ 35, 48 (rev. ed. 1979); DEL. CODE ANN. tit. 8, § 141(e) (1974 & Supp. 1982); N.Y. BUS. CORP. LAW § 717 (McKinney 1963 & Supp. 1984).

their duty of loyalty is more elusive. Although the rule that directors must act in good faith for the corporate, rather than a personal, benefit²⁰ is simply stated, proving the directors' motives is problematic.

The duty of loyalty is difficult to apply in the tender offer context because hostile tender offers create a conflict of interest between target management and the corporation's shareholders.²¹ On the one hand, a new management resulting from a hostile transfer of control, a higher price per share made possible by an auction among bidders, or even the simple ability to sell their stock at a premium above the market price may be in the best interests of the target shareholders. On the other hand, target management's desire to maintain control may spur its resistance to tender offers that are consistent with the financial interests of the corporation, but jeopardize the directors' status and salaries. Indeed, such self-interest may result in the use of defensive tactics that could operate to the financial detriment of both the corporation and its shareholders.

Despite target management's inherent conflict of interest in deciding whether to employ defensive tactics, recent state and federal decisions consistently have applied the business judgment rule to these management decisions.²² Although directors have devised and implemented far reaching defensive tactics, the courts have steadfastly adhered to the business judgment rule without regard to the effectiveness or novelty of

20. See, e.g., *Irving Trust Co. v. Deutsch*, 73 F.2d 121, 123 (2d Cir. 1934) (director may not divert a corporate opportunity for personal gain), *cert. denied*, 294 U.S. 708 (1935); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939) (directors may not use corporate personnel, facilities, or funds for personal gain); *Flynn v. Zimmerman*, 23 Ill. App. 2d 467, 476, 163 N.E. 2d 568, 578 (1960) (director must make full disclosure to corporation that in selling property to corporation he is receiving a personal gain).

21. See, e.g., *Crane Co. v. Harsco Corp.*, 511 F. Supp. 294, 305 (D. Del. 1981) (when stock purchase occurs in context of tender offer, directors have inherent conflict of interest) (citing *Bennett v. Propp*, 41 Del. Ch. 14, 22, 187 A.2d 405, 409 (1962)); *Northwest Indus., Inc. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 712 (N.D. Ill. 1969) (whenever management of target resists tender offer, officers and directors may be accused of preserving their jobs at the expense of the corporation).

22. See, e.g., *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 383 (2d Cir. 1980) (construing New Jersey statute requiring disinterested directors to approve contract between corporation and another director to protect directors under business judgment rule); *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 702-03 (2d Cir. 1980) (directors entering into merger agreement to prevent hostile takeover protected by business judgment rule under New York law); *Johnson v. Trueblood*, 629 F.2d 287, 293 (3d Cir. 1980) (business judgment rule under Delaware law protects majority unless retaining control is the sole motive), *cert. denied*, 450 U.S. 999 (1981); *Cheff*, 41 Del. Ch. at 504, 199 A.2d at 554 (directors' use of corporate funds to purchase its shares held by an outsider seeking control at excessive prices was within directors' business judgment).

these tactics.²³ Courts applying this flexible standard have overwhelmingly held that plaintiffs did not establish the requisite level of proof of management self-interest to overcome the presumption of the business judgment rule.

For example, in *Mills v. Esmark, Inc.*²⁴ and *Whittaker Corp. v. Edgar*,²⁵ the district court evaluated according to the business judgment rule the target boards' decisions to grant golden parachute contracts²⁶ to senior executives and to sell the target's crown jewel.²⁷ In *Buffalo Forge*

23. One defensive tactic recently attempted was the creation of an employee benefit plan. *Norlin Corp. v. Rooney, Pace Inc.*, No. 84-7360 (2d Cir. June 27, 1984). In response to a purchase of almost one third of Norlin's common stock, the board of directors of Norlin, *inter alia*, transferred a block of stock to a newly created ESOP to solidify management's control. *Id.* The court held that the board's actions were not fair and reasonable, and stated that it has never sanctioned a board's decision to lock-up voting power in an effort to buy time during an attempted takeover. *Id.*; see also *Ruling Narrows Defensive Actions To Deter Takeovers*, *Legal Times*, July 2, 1984, at 1, col. 2 (discussing *Norlin*).

Several cases have addressed the issue of creating an ESOP as a defensive tactic in the context of a proxy battle. See *Klaus v. Hi-Shear Corp.*, 528 F.2d 225, 234 (9th Cir. 1975) (creation of employee stock ownership trust as defensive tactic in proxy battle not sufficiently compelling business purpose and therefore management breached its fiduciary duty); *Podesto v. Calumet Indus., Inc.*, [1978 Transfer Binder] *FED. SEC. L. REP. (CCH)* ¶ 96,433, at 93,557 (1978) (creation of employee plan as means to ensure control in proxy contest was a violation of the directors' fiduciary duty and not protected by the business judgment rule because the primary, if not sole, purpose for creation of the plan was to entrench target management in control of corporation). *Contra Texas Int'l Airlines, Inc. v. Continental Air Lines, Inc.*, Civ. No. 81-1831 LTL (kx) (C.D. Cal. June 16, 1981), *aff'd.*, No. 81-5114 (9th Cir. June 18, 1981).

The investment portfolio of a target's employee benefit plan generally contains a significant amount of target stock. Pitt & Miles, *The Use of Corporate Employee Benefit Plans in Hostile Takeovers*, in *NEW TECHNIQUE IN ACQUISITIONS & TAKEOVERS* 506 (Bialkin, Fleischer & Greene eds. 1983). If target management has control or even influence over the target's benefit plan, the extent to which the plan owns target stock could be instrumental in formulating the target's response to a tender offer. The plan could theoretically tender to the offeror, sell its shares in the open market, sell its shares to a party designated by target management, hold them, or attempt to purchase additional target shares. *Id.* If the plan holds a large amount of target stock, its response could be pivotal in ensuring the success or failure of a tender offer because of the significant voting power localized in the plan.

Frequently, corporate officers serve as trustees of their corporation's benefit plan. When the officers serve in this capacity and the plan owns a block of the corporation's stock, the target officers, in a hostile tender offer, face a potential conflict of interest. On the one hand, as corporate officers, they owe a fiduciary duty to the corporation and its shareholders. On the other hand, as trustees of the benefit plan, they owe a fiduciary duty to the plan and its participants. It may, for example, be in the best interests of the target corporation to fight the tender offer, but nevertheless in the best interests of the plan's participants for the plan to tender its stock to the bidder and thereby obtain the premium associated with the offer.

24. 544 F. Supp. 1275 (N.D. Ill. 1982).

25. 535 F. Supp. 933 (N.D. Ill.), *aff'd.*, No. 82-1305 (7th Cir. 1982).

26. See *supra* note 4 & accompanying text.

27. The target's sale of its crown jewel is but one form of "lock-up," namely, an arrangement by which the target corporation in a hostile takeover gives one bidder a competitive

Co. v. Ogden Corp.,²⁸ the Second Circuit confirmed that the business judgment rule applied to lock-ups.²⁹ In addition, in *Pogo Producing Co. v. Northwest Industries, Inc.*,³⁰ a federal district court reaffirmed the broad scope and applicability of the business judgment rule to target management's defensive measures, including issuer tender offers.³¹ Finally, in *Bendix Corp. v. Martin Marietta Corp.*,³² the Maryland district court accepted the Pac-Man defense³³ as a valid defensive tactic that the business judgment rule would protect.³⁴ In essence, the courts have treated management decisions made during a hostile tender offer like other difficult issues that a board of directors often faces.

advantage over other actual or potential bidders for the target's stock. For a further explanation of lock-ups, see *infra* note 29.

28. 717 F.2d 757 (2d Cir.), *cert. denied*, 104 S.Ct. 550 (1983).

29. *Id.* at 759. In addition to the crown jewel option, the most common kinds of lock-ups are the stock purchase agreement and the stock option agreement. The stock purchase and stock option lock-up consist of an agreement with or option to the friendly offeror to purchase the target's treasury shares or authorized but unissued shares that may have special voting rights. As a result, the bidder holding this agreement or option has the advantage of a large initial equity position in the target and perhaps special voting privileges, either of which has the desired effect of discouraging hostile bidders. *But see* *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 374-75 (6th Cir. 1981) (lock-up options to sell significant oil reserves found manipulative and therefore violative of § 14(e) of Securities Exchange Act of 1934). The danger of lock-ups is that they often disregard the best interests of the shareholders, while protecting directors. Target directors will likely have greater job security if control shifts to a friendly bidder who has been given a lock-up option. The ultimate result, however, may be that the shareholders receive a lower price for their tendered stock than would be generated through unrestrained competitive bidding.

30. Civ. No. H-83-2667 (S.D. Tex. May 24, 1984).

31. The target company employing a self-tender as a defensive tactic is faced with several problems. First, target shareholders may be unwilling to risk proration of their shares in the hands of the target, even for a higher price, if the limited self-tender is in response to an any-and-all cash tender offer by the raider. Second, the self-tender might cause the target to incur excessive debt in an effort to purchase its outstanding shares. Third, because repurchased shares are treated as treasury shares, they may not be voted pursuant to the corporate law of most states. *See, e.g.*, DEL. CODE ANN. tit. 8, § 160(c) (1974 & Supp. 1982); N.Y. BUS. CORP. LAW § 515 (McKinney 1978). Because the repurchased shares may not be voted, the self-tender ironically may serve to increase the offeror's percentage of shares outstanding and therefore result in a successful bid.

An issuer tender offer deters hostile takeovers in two ways. First, the issuer offer, particularly if the price exceeds the hostile offer, may cause the price of the target stock to rise. If the stock price rises, it becomes more expensive for the offeror to acquire the target. Secondly, the reduction in the number of outstanding shares caused by the issuer tender offer may make it impossible for the offeror to purchase enough stock to meet its goal if the remaining outstanding shares are friendly to target management.

32. 549 F. Supp. 623 (D. Md. 1982).

33. *See supra* note 2 & accompanying text.

34. *Bendix*, 549 F. Supp. at 633-34. The court also found that no violation of the federal securities laws occurred. *Id.* at 631 (no "plans" or "detailed schemes" were created; therefore, no violation of § 14(e) of the Securities Exchange Act of 1934 existed for failure to disclose).

The consequence of treating decisions to engage in defensive tactics like other business decisions is that courts presume the directors have fulfilled their fiduciary duties unless the plaintiffs can demonstrate that the directors' personal interests thwarted their duty of loyalty.³⁵ Although acknowledging that target directors frequently are motivated, at least to some degree, by the desire to remain in office, courts have concluded that decisions made with such self-interest do not constitute per se a breach of loyalty.³⁶ Therefore, the courts require proof of more than a mere desire to remain in control before they will find a breach of loyalty and deny the protection of the business judgment rule.

Although courts have phrased the standard of proof in different ways, a series of decisions has established a high threshold for plaintiffs to prove that the directors' defensive tactics constituted a breach of their loyalty.³⁷ One component of the standard is the presumption that management decisions to defend against hostile takeovers are valid. For example, in *Whittaker Corp. v. Edgar*,³⁸ the federal district court held that the decision of the target board to sell its crown jewel³⁹ enjoyed a presumption of sound business judgment that the court will not disturb if

35. See, e.g., *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757, 789 (2d Cir. 1983) (mistake for court to substitute its business judgment for directors'); *Pogo Prod. Co. v. Northwest Indus.*, Civ. No. H-83-2667 (S.D. Tex. May 24, 1984); *Beebe v. Pacific Realty Trust*, 578 F. Supp. 1128, 1138 (D. Or. 1984) (evidence showed that directors' recommended price per share was in the best interest of stockholders and not for any self-interest); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (presumption that directors act on informed basis in good faith and in best interests of company in making business decisions).

36. In *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir.), cert. denied, 450 U.S. 999 (1981), the court explained that a director has a certain amount of self-interest in everything he does. *Id.* at 292. The business judgment rule seeks to alleviate this problem by validating certain situations that otherwise would constitute a conflict of interest. *Id.*

37. *Johnson*, 629 F.2d at 293 (plaintiff must show that motive to retain control was primary or sole purpose); *Panther v. Marshall Field Co.*, 486 F. Supp. 1168, 1194 (N.D. Ill. 1980) (plaintiff must show fraud, bad faith, gross overreaching, or abuse of discretion), *aff'd*, 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); *Aronson*, 473 A.2d at 812 (plaintiff must show gross, not just simple, negligence).

In a few cases, the courts have applied a "primary purpose" test that purports to invalidate target management's defensive action if the primary goal was to maintain management's control. See, e.g., *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 230 A.2d 769 (1967) (target board's issuance of stock to friendly persons in order to frustrate a takeover was not self-serving). Although the primary purpose formulation sounds more strict than the business judgment rule, in practice there is little difference between the two. A. FLEISCHER, *TENDER OFFERS; DEFENSES, RESPONSE AND PLANNING*, 88-5 to 88-4 (1981); Lipton, *Takeover Bids in the Targets' Boardroom: An Update After One Year*, 36 BUS. LAW. 1017, 1022-23 (1981) (primary purpose test and business judgment rule essentially demand no more than good faith and due care) [hereinafter cited as Lipton, *An Update*].

38. 535 F. Supp. 933 (N.D. Ill.), *aff'd*, No. 82-1305 (7th Cir. 1982).

39. See *supra* note 3 & accompanying text.

the decision can be attributed to *any* rational business purpose.⁴⁰

Moreover, other courts have required a showing of bad faith to overcome the presumption of validity. In *Treadway Companies v. Care Corp.*,⁴¹ the Second Circuit, reviewing the decision of Treadway's board to fight a tender offer by selling stock to "friendly hands,"⁴² held that the plaintiff must show that the directors "acted in bad faith, or in furtherance of their own interests, or for some other improper purpose."⁴³ Similarly, in *Panter v. Marshall Field & Co.*,⁴⁴ the Seventh Circuit, considering the target's acquisitions that created an antitrust claim against the bidder,⁴⁵ held that the plaintiff failed to meet its burden of showing that the defendant board had breached its fiduciary duties because the plaintiff had presented no evidence of bad faith, self-dealing, fraud, or overreaching "sufficient to give rise to any reasonable inference that impermissible motives predominated in the board's consideration of the takeover proposal."⁴⁶

The effect of rebutting the presumption highlights the degree of protection that the business judgment rule provides. A plaintiff who demonstrates management's improper motive only shifts to the directors the burden of proving that the primary reason for their disputed decision was to further a legitimate business purpose. Contrary to the plaintiff's burden, management's burden on rebuttal is easily met. A number of business reasons can be proffered to explain why a target may consider a takeover undesirable and decide to resist. For example, the target board may consider the offering price inadequate or the selling time inappropriate;⁴⁷ management may seek to protect the corporation's direction or

40. *Whittaker*, 535 F. Supp. at 950-51; see also *Gearhart Indus. Inc. v. Smith Int'l, Inc.*, 592 F. Supp. 203, 225 (N.D. Tex. 1984) (refusing to question business judgment of directors without showing of bad faith).

41. 638 F.2d 357 (2d Cir. 1980).

42. The sale of authorized but unissued stock to "friendly hands," an ally who is likely to side with management in a contest for control, can be an effective defensive tactic. Both the New York Stock Exchange and the American Stock Exchange, however, require shareholder approval if the stock sale constitutes 20% or more of the corporation's outstanding stock. NYSE Company Manual A-284; AMEX Company Guide § 713. The placement of stock in friendly hands is frequently accompanied by a "standstill agreement," limiting the buyer's right to acquire more shares or dispose of the newly acquired shares as a block.

43. *Treadway*, 638 F.2d at 381.

44. 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

45. *Id.* at 297. After the President of Carter-Hawley-Hale indicated he would begin a takeover for Marshall Field, Marshall Field purchased competitors of the bidder and then initiated an antitrust suit against Carter-Hawley-Hale. *Id.*

46. *Id.* at 279-80.

47. Lipton, *An Update*, *supra* note 37, at 1026-28 (outlining procedures to be followed by board confronted with a hostile tender offer).

continued existence; or, it may determine that significant legal impediments bar consummation of the takeover.⁴⁸ In fact, even a motive to perpetuate incumbent management's control can constitute a proper business purpose if consistent with the corporation's best interests.⁴⁹

By endowing directors' decisions to engage in defensive tactics with the same protection granted to routine board decisions, the courts have sidestepped the inherent conflict of interest confronting target management engaged in defensive tactics. Despite the likelihood that the directors' desire to retain control, rather than the interests of the corporation, may be the primary motive for defensive tactics, the courts have taken a hands-off approach to these loyalty cases and have permitted target management great freedom to devise and to implement defensive tactics that could hinder the shareholders' ability to tender their stock.

Fiduciary Duties Under Statutory Corporate Law

In addition to common law principles of fiduciary law, state corporation statutes contain several provisions that can be relevant during a tender offer.⁵⁰ For example, corporations must act in accordance with state requirements when they enact charter amendments incorporating "shark repellent" provisions.⁵¹ Other corporate statutory provisions au-

48. *Id.*

49. See *Cheff v. Mathes*, 41 Del. Ch. 494, 504, 199 A.2d 548, 554 (1964) (directors not liable where they sincerely believed that buying out dissident shareholder was necessary to maintain proper business practices). Furthermore, in *Crane Co. v. Harsco Corp.*, 511 F. Supp. 294 (D. Del. 1981), the court observed that the board

can either show that some consideration other than the perceived threat to control was the primary reason for the stock purchase; or it can admit that the stock purchase was intended primarily as a defensive maneuver, and show that the directors reasonably determined that a change in control would constitute a "clear threat to the future business or the existing, successful business policy" of the corporation.

Id. at 305.

50. In addition to regulating major corporate transactions, state corporate statutes regulate the conduct of directors. See, e.g., MODEL BUSINESS CORP. ACT § 35 (rev. ed. 1979) (director shall perform duty as director in good faith, in a manner he reasonably believes to be in the best interest of the corporation, and with such care as ordinarily prudent person in a like position would use); see also CAL. CORP. CODE § 309 (West 1977 & Supp. 1984) (director shall perform duties in good faith in a manner such director believes to be in the best interests of the corporation and with the care of an ordinarily prudent person); N.Y. BUS. CORP. LAW § 717 (McKinney 1963 & Supp. 1984) (director to perform duties in good faith and with the degree of care an ordinary prudent person in a like position would use).

51. See generally Hochman & Folger, *Deflecting Takeovers: Charter and By-laws Techniques*, 34 BUS. LAW. 537 (1979) (discussing charter and by-law amendments to deter takeovers). Shark repellents may be adopted to deter offers in general or to deter specific offers. Even if the offeror is not deterred from making its offer, such structural changes can delay the takeover attempt long enough to give the target a meaningful opportunity to consider and implement specific defensive measures. Furthermore, even if the takeover attempt is success-

thorizing dividend plans,⁵² by-law amendments,⁵³ the power to call a

ful, the implementation of shark repellents may serve to prevent quick takeovers, thus reducing the pressure on the target shareholders to tender their shares for the initial offering price. *Id.* at 554.

The courts generally have upheld the use of traditional shark repellent provisions in the corporate charter or by-laws if the provisions have been enacted properly, notwithstanding the fact that they are specifically designed to discourage hostile takeovers. *See, e.g., Seibert v. Gulton Indus., Inc.*, Civ. No. 5631 (Del. Ch.), *aff'd without opinion*, 414 A.2d 822 (Del. 1980). In *Seibert*, the court upheld a charter provision enacted in accordance with statutory requirements mandating the approval of 80% of the shareholders for a takeover by a shareholder who owned at least 5% of the target stock, unless the board approved the takeover before the bidder acquired its 5%. *Contra Telvest, Inc. v. Olson*, Civ. No. 5798 (Del. Ch.) (target board's attempt to alter the voting rights of existing shareholders by imposing an 80% supermajority requirement for approval of a takeover was illegal because the few preferred shareholders, also friendly to management, would then have been able to negate any tender offer), *appeal denied*, 405 A.2d 132 (Del. 1979).

52. Two types of dividend plans have gained popularity as defensive tactics: the warrant dividend plan and the convertible preferred stock plan. The warrant dividend plan gives a dividend to the target shareholders in the form of a warrant to buy target common stock. The warrant is triggered either when a tender offer is made or when a substantial position in the target corporation is acquired. Similarly, the convertible stock dividend plan gives stock dividends in the form of convertible preferred stock that is convertible into common stock when someone acquires a substantial position in the target corporation. *See Note, Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964, 1964-65 (1984).

The purpose of issuing these dividends is to assure that the shareholders obtain a fair price in the event a tender offer is commenced. The plans, therefore, seek to deter (i) a two-step merger process in which, by merger after a partial tender offer, nontendering shareholders can be removed from the corporation at a price below that paid to tendering shareholders; or (ii) a "bootstrap" acquisition by an offeror in which the offeror acquires less than 50% of the stock in an initial tender and uses the assets of the target to effectuate a second-step merger at a later date.

Although the plan may deter a raider, it also has costs to the target. The warrants create a large overhang that may adversely affect the market price of the target's common stock as well as inhibit common stock financing. Moreover, the plan deters friendly deals as well as hostile deals unless the plan provides that the provisions are inapplicable when the triggering transaction was approved by the target's existing board of directors.

The legality of these plans has just begun to be tested. The common charge that management has promulgated the plans to secure its own position is unlikely to succeed. Because the courts have given management wide leeway with other defensive tactics, and because this tactic has benefits to the target shareholders lacking in other tactics, a charge that enactment of these plans is a violation of management's duty of loyalty is unlikely. For example, recently in *Moran v. Household Int'l, Inc.*, No. 7730 (Del. Ch. Jan. 29, 1985), the Delaware court upheld, on the basis of the business judgment rule, a preferred stock dividend plan intended as a defensive tactic to possible tender offers. The court said that the business judgment rule would protect directors if the corporation adopted the dividend plan prospectively, rather than during the heat of a takeover battle. *Id.*; *see also Delaware Rulings Complicate Poison Pill Picture*, Legal Times, Feb. 4, 1985, at 9, col. 1.

53. For example, the Delaware statute permits stockholders and, if the charter so provides, the directors of a Delaware corporation to amend the by-laws. DEL. CODE ANN. tit. 8, § 109(a) (1974 & Supp. 1982).

The primary issue in by-law amendments, as with other defensive tactics, is management's

meeting of the stockholders,⁵⁴ and consent in lieu of a meeting of the stockholders⁵⁵ recently have emerged as pivotal factors in defending against takeovers.

Like fiduciary law, the statutory law lacks a standard that is appropriate to resolve the issues raised by management's inherent conflict of interest. Because the statutes delineate specific requirements, defendants can argue convincingly that their duties of care and loyalty are satisfied once they have complied with the statutory provisions. In deference to the legislatures, courts refrain from imposing stricter fiduciary duties on the theory that, if the legislatures wanted additional requirements, it would have imposed them.

Such deference is inappropriate, however, because the legislatures intended these provisions to govern decisions of ordinary corporate governance, not the tender offer context. This distinction is critical because we assume managers act for the corporate weal when, for example, they propose a charter amendment or unilaterally revoke a by-law. In contrast, when management takes identical action in response to a tender offer, the motive for such action must be questioned. Yet the relevant state statutory law does not require motive to be considered.

motive in making the amendment. Simply because it is legally possible for target management to amend the by-laws does not make it per se lawful to do so. *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971). Management's efforts to use the corporate machinery and the state corporate law must be tested by whether its motive was to perpetuate itself in office or to effectuate some corporate good. *Id.*

54. The differences in the state statutes empowering various parties to call a special meeting of the stockholders is significant. The board always has this power. In a jurisdiction following the Delaware approach, no shareholder can call a meeting without by-law authorization. Therefore, if the target did not enact a by-law negating the Delaware norm, the offeror is disadvantaged because it will be required to wait until the next annual meeting of the stockholders before it can replace the target's board of directors. *See DEL. CODE ANN. tit. 8, § 211 (1974 & Supp. 1982)*. In a jurisdiction following the Maryland approach, however, anyone owning 25% of the stock can call a meeting. In these jurisdictions an offeror would have the advantage of being able to call a special meeting of the stockholders upon acquisition of the statutorily decreed percentage of the target's stock. *See MD. CORPS. & ASS'NS CODE ANN. § 2-502 (1975 & Supp. 1983)*.

55. In Delaware, unless the corporate charter provides otherwise, if a stockholder has votes sufficient to effectuate an action at a meeting of the stockholders, he may do so without a meeting, notice, or vote. *DEL. CODE ANN. tit. 8, § 228 (1974 & Supp. 1982)*. In lieu of the meeting, obtaining the requisite number of consents to effectuate the stockholder action will suffice. In Maryland, however, no stockholder action may be taken without a meeting absent unanimous consent by the stockholders. *See MD. CORPS. & ASS'NS CODE ANN. § 2-505 (1975 & Supp. 1983)*.

Deficiencies of the Current Practice and Alternative Proposals

Deficiencies of the Business Judgment Standard

As discussed in Part I, despite the conflict of interest faced by target directors when confronted with a tender offer, most courts apply the business judgment rule to the directors' decisions to engage in defensive tactics just as the courts would apply the rule to any other corporate transaction. When a court applies the rule to management's decisions to engage in defensive tactics, however, it overlooks a central issue: although the rule presupposes that the directors have fulfilled their fiduciary duties of care and loyalty,⁵⁶ target directors may be diverted from fulfilling that unbiased, selfless duty of loyalty⁵⁷ because the tender offer threatens the target management's job security. Although courts have acknowledged this conflict, they have held that this conflict alone is insufficient to deny the application of the rule. Courts have reasoned that because the desire to remain in office motivates nearly all target director decisions, plaintiffs must prove something more than an inherent conflict for courts to deny the application of the business judgment rule.

Thus, a court may require the plaintiffs to prove that maintaining control was management's sole, or at least primary, purpose in fighting the tender offer.⁵⁸ Generally, if management has acted to maintain its control as well as to further a corporate interest, the courts have concluded that management did not breach its duty of loyalty and, accordingly, courts have applied the business judgment rule.⁵⁹ This line of reasoning, however, contains a significant flaw. Management often can posit some legitimate corporate purpose for its conduct. Judicial inquiry into management's motive, therefore, becomes a futile exercise in all but the most blatant cases of management misconduct.

Other courts have implied that management can satisfy its duty of

56. See *supra* notes 16-21 & accompanying text.

57. In *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503 (1939), the court stated, "The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest." *Id.* at 270, 5 A.2d at 510.

58. See *supra* notes 25, 30 & accompanying text.

59. For a discussion of whether courts place too much weight on the role of so called "independent" directors, see Werner, *Corporation Law in Search of Its Future*, 81 COLUM. L. REV. 1611, 1656-58 (1981) (courts' deference to outside directors' judgment impairs shareholders' protection against management abuses). See, e.g., *Mobil Corp. v. Marathon Oil Co.*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,375, at 92,262, 92,265-66 (S.D. Ohio 1981) (noting that directors each have, to some degree, a personal stake in outcome), *rev'd on other grounds*, 669 F.2d 366 (6th Cir. 1981). *Contra* Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231, 1235 (1980) (majority of directors often not affiliated with management and take responsibilities to shareholders seriously) [hereinafter cited as Lipton, *A Response*].

loyalty by fulfilling its duty of care. In *Cheff v. Mathes*,⁶⁰ for example, the directors of Holland Furnace Company, fearing a takeover, used corporate funds to repurchase stock from a well-known "raider."⁶¹ The Delaware court decided that only those directors who had a personal pecuniary interest in the repurchase had to prove their loyalty; all other directors were entitled to the presumption of loyalty.⁶²

In determining whether management acted for a corporate, rather than a personal, benefit, however, the court in *Cheff* considered facts that were more probative of whether management exercised due care.⁶³ The court noted that Holland's directors had solicited advice about the raider, Holland's capital structure, and the proposed repurchase.⁶⁴ The solicitation of advice the court cited, however, concerned the care exercised by the board, but did not probe whether personal goals motivated the repurchase. The court made no inquiry about whether Holland's shareholders would be harmed or what Holland's directors would lose if the raider were successful in its takeover. The court merely relied on the determination of Holland's board that incumbent management would better serve Holland.⁶⁵

Thus, the court in *Cheff* blurred the distinction between the two components of management's fiduciary duty to shareholders. Inquiry into the duty of care is simpler than inquiry into the duty of loyalty because in establishing its duty of care management can demonstrate concrete steps it took to decide whether to fight the tender offer. In contrast, the inquiry into management's motivation, which is necessary to deter-

60. 41 Del. Ch. 494, 199 A.2d 548 (1964).

61. *Id.* at 499-500, 199 A.2d at 551-52. Corporate funds were expended although one of the directors, who was also a shareholder, was willing to buy the raider's stock. *Id.* at 502, 199 A.2d at 552-53.

62. *Id.* at 505, 199 A.2d at 554-55. By not requiring directors who did not have a personal pecuniary interest other than stock ownership to prove their loyalty, the court implicitly held that the directors' fear of losing their positions did not create a sufficient conflict of interest to warrant denial of the business judgment rule. *Id.*

63. *Id.*

64. *Id.* at 507-08, 199 A.2d at 556. Shortly after trading in Holland's stock increased, the raider announced to the board that he owned a substantial number of Holland shares. The board investigated the financial and business history of the raider, learning that the raider had participated in the liquidation of a number of companies for quick profits. *Id.*

65. Professor Gilson notes that the court in *Cheff* was ill-equipped to review the fairness of management's decision, but was better able to inquire into management's motives. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 828-29 (1981). The court required management to show that it had made a reasonable investigation which showed a policy conflict between management and the raider; this conflict afforded management decisions of the business judgment rule. *Id.*

mine whether management has satisfied its duty of loyalty, is mired in the difficulty of determining another person's primary motive.

Other courts following the reasoning in *Cheff* abdicated their responsibility to protect shareholders by policing management. Although difficult, the analysis of management's loyalty is not a new task for judges, who have made such evaluations in other contexts.⁶⁶ The fiduciary duty of care is no substitute for the fiduciary duty of loyalty.⁶⁷

Deficiencies of the Statutory Standard

Judicial decisions that evaluate directors' conduct in a tender offer context according to state statutory law, as if they were evaluating an ordinary business decision, are also subject to criticism. The state corporation statutes reflect the state legislatures' judgment about the desirability of shareholder involvement in certain corporate actions.⁶⁸ For example, some statutory sections permit management action without a shareholder vote.⁶⁹ Legislatures designed such statutes, however, for circumstances that presuppose a specific standard of conduct: that management's activities are guided by their fiduciary obligations. Thus, allowing management to amend the by-laws to prevent shifts in control, albeit amidst management allegations of corporate good, abuses the statutory process because in the takeover context the prerequisite satisfaction of fiduciary duties is not assured. Although acknowledging that the statutory standard is oblivious to management's conflicts of interest, courts essentially have ignored whether state corporation statutes actually authorize management to defend against a takeover.

66. See, e.g., *Irving Trust Co. v. Deutsch*, 73 F.2d 121 (2d Cir. 1934) (discussing management's duty of loyalty not to appropriate corporate opportunity for itself), *cert. denied*, 294 U.S. 708 (1935); *Schreiber v. Bryan*, 396 A.2d 512 (Del. Ch. 1978) (discussing directors' duty not to usurp corporate opportunity); *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 93 A.2d 107 (1952) (analyzing directors' fiduciary duty in proposed merger of parent and subsidiary corporations); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969) (discussing directors' fiduciary duty in trading of corporation's stock); *Everett v. Phillips*, 288 N.Y. 227, 43 N.E.2d 18 (1942) (looking to directors' duty of loyalty in dealings between common corporations).

67. See Gilson, *supra* note 65, at 830-31 (incongruous to apply the duty of care standard designed for nonconflict of interest business judgment situations to test for compliance with the duty of loyalty which is at issue only in conflict of interest situations, such as management's self-interest in defensive tactics).

68. For example, in mergers, sales of assets, liquidations, and charter amendments, statutes require a shareholder vote. See, e.g., DEL. CODE ANN. tit. 8, § 242 (amending articles of incorporation), § 251 (mergers), § 271 (sale of substantially all corporate assets), § 275 (dissolution) (1983).

69. For example, many statutes authorize management to amend the by-laws without shareholder consent to allow management flexibility in running the corporation.

The assumption that management has a right to take corporate action in response to a tender offer should be questioned. Although most statutes grant the directors broad powers to conduct the business of the corporation,⁷⁰ the statutes explicitly restrict the directors' role in transactions outside the corporation's usual and ordinary business. Thus, statutes require shareholder approval for corporate transactions such as mergers, sales of assets, liquidations, and charter amendments.⁷¹ Other statutes nevertheless permit management action without a shareholder vote in certain situations normally outside the ordinary course of business. For example, many statutes authorize management to amend the by-laws⁷² or to approve certain types of mergers without a shareholder vote.⁷³ Generally, however, state corporate statutes are silent as to target management's role in the tender offer context. If the legislatures were deliberately silent about target management's role in tender offers, two theories may explain this statutory silence. According to one view, the state legislatures refrained from authorizing tender offer defenses in recognition that tender offers can fulfill their function of displacing inefficient or self-dealing management only if target management is prevented from exercising a veto power.⁷⁴ For example, if the directors, whose approval is required under state law, refuse to approve the merger, the acquiror can begin a tender offer. The threat of a tender offer would help to constrain any management self dealing in its decision to reject the merger. If a statute permitted target management to engage in effective defensive tactics without shareholder approval, the bidder would be unable to take over the target without management's approval, and management self-dealing would be difficult to prevent.⁷⁵

Another explanation for the statutory silence is that tender offers, unlike mergers or sales of corporate assets, are not corporate transactions. Arguably, a tender offer is only a transfer of stock ownership, a mere shareholder investment decision over which management should

70. See, e.g., CAL. CORP. CODE § 300 (West 1977 & Supp. 1984); DEL. CODE ANN. tit. 8, § 141 (1983); N.Y. BUS. CORP. LAW § 701 (McKinney 1963 & Supp. 1983-1984).

71. See *supra* note 68.

72. See, e.g., CAL. CORP. CODE § 211 (West 1977); DEL. CODE ANN. tit. 8, § 109 (1983); N.Y. BUS. CORP. LAW § 601 (McKinney 1963 & Supp. 1983-1984).

73. See, e.g., CAL. CORP. CODE § 1101 (West 1977 & Supp. 1984); DEL. CODE ANN. tit. 8, § 251 (1983); N.Y. BUS. CORP. LAW § 902 (McKinney 1963 & Supp. 1983-1984).

74. Gilson, *supra* note 65, at 844 ("market for corporate control is the principal constraint on management self-dealing" and inefficiency). Professor Gilson suggests that the silence may reflect the legislative presumption of the free alienation of property, whereby management's nonrole is assumed. *Id.* at 849.

75. *Id.* at 844-45 (constraints on management decrease if incumbent management can increase costs of tender offer).

have neither control nor veto power.⁷⁶

Scholars who support an active management role in response to a tender offer argue that although the tender offer is a stock purchase in form, it is functionally equivalent to an asset purchase.⁷⁷ Proponents of this theory maintain that because management controls the terms for a sale of assets, it should also have broad discretionary authority in a tender offer context.⁷⁸ State corporate statutes, however, often reject this functional equivalence concept, reflecting the notion that the structure of a transaction, rather than its result, determines the process.⁷⁹ Moreover, although tender offer defensive tactics currently are the focus of much attention, the state legislatures have not enacted provisions that create a role for target management in tender offers comparable to its role in either asset sales or merger.⁸⁰

The Fairness Test

Although courts have acknowledged the inherent conflict of interest in a tender offer context, they overwhelmingly have chosen to evaluate management actions according to the business judgment rule rather than conflict of interest principles.⁸¹ In most jurisdictions, if a fiduciary has a conflict of interest, common law or state statutory provisions uphold the transaction in three circumstances: if independent directors approved

76. Cf. *id.* at 849 (management need not have any affirmative role in tender offers). For example, a shareholder owning a controlling block of stock may sell that block without any approval from the corporation's officers, directors, or shareholders, even though the sale will ultimately effect transfer of control over the corporation's assets. *Id.* at 849.

77. Gilson, *supra* note 65, at 848; see also Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 61 CHI. B. REC. 152, 154 (1979) (the only difference between a merger and tender offer is that a tender offer is made directly to shareholders); Lipton, *Takeover Bids*, *supra* note 11, at 104, 116 (takeover bids are not substantially different from other major business decisions); Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882, 892 (1978) (tender offer is an alternative acquisition technique, and "management's position [is] identical to that occupied in conventional statutory merger or sale").

78. Gilson, *supra* note 65, at 848 & n.106.

79. See, e.g., VA. CODE § 13.1-77(d) (1978) (specifying that a transaction involving a sale or exchange of assets "shall not be considered to be a merger or consideration").

80. Gilson, *supra* note 65, at 847-48 (merger process rests firmly in management's control, but statutes give no role to management in tender offers).

81. Several judges have expressed dissatisfaction with decisions applying the business judgment rule to management's decisions to engage in defensive tactics. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271, 299 (7th Cir.) (Cudahy, J., concurring in part, dissenting in part) (emphatically disagreeing that the business judgment rule should clothe directors fending off a threat to their control), *cert. denied*, 454 U.S. 1092 (1981); *Johnson v. Trueblood*, 629 F.2d 287, 300-01 n.6 (3d Cir. 1980) (Rosenn, J., concurring in part, dissenting in part) (difficult to determine exactly what subjective motive was involved or whose motive was involved), *cert. denied*, 450 U.S. 999 (1981).

the transaction; if the shareholders approved the transaction; or if the interested fiduciary proved the transaction was fair to the corporation.⁸² Because all the directors have an inherent conflict of interest in the tender offer situation,⁸³ and they generally do not submit the transaction to the shareholders for approval, the court's only option would be to require that the directors prove the "fairness" of the questioned defensive tactic.⁸⁴

Evaluation of the fairness of defensive tactics is complex. The focus of the inquiry is not whether management wasted the corporation's assets or whether target management received a fair price, but whether it was fair for management to have undertaken the defensive transaction at all, at any price. For example, if target management repurchased an insurgent's stock, a fairness test would necessarily focus on the fairness of preventing a shift in control,⁸⁵ rather than the fairness of the repurchase price, because "management's conflict of interest goes not to the commercial reasonableness of the defensive action's terms, but to the decision to block a change in control."⁸⁶

If a court must decide whether the defensive tactic was appropriate at any price, however, the court is in the position of inquiring into an area that it is not equipped to handle: evaluating complex corporate decisions. Because one justification for the creation of the business judgment rule was to avoid the necessity for the courts to make complex business

82. See, e.g., MODEL BUSINESS CORP. ACT § 41 (1979); CAL. CORP. CODE § 310 (West 1977 & Supp. 1984); DEL. CODE ANN. tit. 8, § 144 (1983); N.Y. BUS. CORP. LAW § 713 (McKinney 1963 & Supp. 1983-1984); see also *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App. 2d 405, 418, 241 P.2d 66, 74 (1952) (transaction between corporation and interested directors not void under state corporation statute if interest is disclosed and transaction approved by shareholders); *Rapoport v. Schneider*, 29 N.Y.2d 396, 402, 278 N.E.2d 642, 646, 328 N.Y.S.2d 431, 437 (1972) (resolution valid if majority of disinterested directors vote in favor.); cf. *Fliegler v. Lawrence*, 361 A.2d 218, 221-22 (Del. 1976) (interpreting state corporation statute as merely removing the cloud on "interested director" when its terms are met).

83. See *supra* note 59 & accompanying text.

84. See, e.g., *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980); *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 702 (2d Cir. 1980).

85. Professor Gilson has aptly analyzed the problem when management repurchases an insurgent's stock:

Management's conflict of interest was not in the price paid, but in the decision to acquire the shares at all. Applying a fairness standard to this decision, however, requires a court to determine whether it was "fair" for control to remain with management rather than shift to the offeror. And this inquiry must necessarily focus on whether the shareholders would be selling their shares. But this is an investment decision, made continually by shareholders . . . and raises the same issue of judicial competence which justifies a restrictive judicial role

Gilson, *supra* note 65, at 827.

86. *Id.*

decisions,⁸⁷ it is not surprising that courts have invoked the business judgment rule simply to avoid engaging in evaluations that would be required by the fairness test.

Scholarly Proposals for Legislation

Scholars have proposed legislation as an alternative to regulating defensive tactics by the business judgment rule.⁸⁸ These proposals are premised on an evaluation of the inherent worth of tender offers as business transactions, an evaluation which, because it entails determinations of fact and policy, is within the province of the legislature, not the courts. Because neither the business judgment rule nor the fairness test is well-tailored to evaluate the competing interests inherent in defensive tactics, the legislative proposals that follow may offer the best solution.

Judge Easterbrook and Professor Fischel, rejecting the business judgment rule as inappropriate for resolving the inherent conflict of interest, have proposed legislation requiring the directors of a target to remain totally passive in the face of a takeover bid.⁸⁹ Judge Easterbrook

87. See *supra* note 14 & accompanying text.

88. The SEC recently endorsed most of the recommendations made by its Tender Offer Advisory Committee. The SEC agreed with the Committee that target company defensive tactics generally should be tested under the business judgment rule, but revised this rule to place greater emphasis on potential conflicts of interest. The SEC also agreed that the use of golden parachutes should be forbidden, but suggested that the tactic be prohibited at the threat of a tender offer rather than at the commencement of an offer. The SEC accepted the Committee's recommendation that there be no general restrictions on counter tender offers, such as the Pac-Man defense, so long as they reflect management's reasonable business judgment. The SEC rejected the Committee's recommendation to forbid the use of charter and by-law defenses as too intrusive into state corporate law. See *SEC Endorses Most Tender Offer Advisory Committee Recommendations*, FED. SEC. L. REP. (CCH) No. 1064, 1-3 (Mar. 21, 1984).

On May 22, 1984, the SEC proposed to Congress legislation requiring shareholder approval for two defensive tactics: the issuance of a new class of securities of more than 5% of the issued and outstanding stock, and the repurchase of stock at a premium from anyone owning more than 3% of the target's stock ("greenmail") for less than two years. In the latter case, a shareholder referendum can be avoided if a similar offer is made to all the shareholders. See H.R. 5693, 98th Cong., 2d Sess. (1984); H.R. 5694, 98th Cong., 2d Sess. (1984); H.R. 5695, 98th Cong., 2d Sess. (1984); see also S. 2754, 98th Cong., 2d Sess. (1984); H.R. 5972, 98th Cong., 2d Sess. (1984); *SEC to Send Congress Tender Offer Reform Legislation*, FED. SEC. L. REP. (CCH) No. 1072, 2-3 (May 16, 1984).

89. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1194 (1981) [hereinafter cited as Easterbrook & Fischel, *The Proper Role*]; Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733, 1739 (1981) [hereinafter cited as Easterbrook & Fischel, *Takeover Bids*]. The authors give two reasons why the business judgment rule is inapplicable to a tender offer situation. First, the presumption that managers will make decisions that maximize shareholders' welfare has never been applied where acute conflicts of interests arise, such as in hostile tender offer situations which, "if successful, frequently result in the replacement of incumbent managers." *Id.* at 1745. Second, "the rationale underlying the rule—the

and Professor Fischel believe that tender offers should be encouraged because they benefit target shareholders and the economy by maximizing share prices and reducing costs.⁹⁰ Conversely, tactics that frustrate a tender offer should be prohibited because they ultimately penalize the economy. By discouraging the takeover,⁹¹ defensive tactics hinder the movement of assets to more efficient management and shareholders.

Scholarly criticism of the Easterbrook-Fischel proposal focuses on three points. First, some scholars challenge the premise that tender offers benefit the economy.⁹² Second, others dispute the conclusion that passivity is the cure for target management's self-interest in the tender offer context. For example, Mr. Lipton claims that target management is able to engage in defensive conduct and to fulfill its fiduciary duties in a tender offer.⁹³ Finally, certain scholars believe that the Easterbrook-Fischel proposal wrongly focuses on the form of the tender offer transaction rather than on its substance. In form, the tender offer entails many individual investment decisions. In substance, however, the shareholders' decisions collectively can effect a sale of the corporate assets. These critics of the Easterbrook-Fischel approach thus contend that target management should be allowed to bargain for the collective interest of the shareholders and the corporation.⁹⁴

Although the business judgment rule is ill-suited to governing defensive tactics, and tender offers are more analogous to individual investment decisions than to corporate transactions such as asset sales or mergers, this author does not agree that the resolution of these problems lies in requiring management passivity. As Parts III and IV of this Commentary explain in detail,⁹⁵ I believe the solution lies in allowing the

inability of courts to make better decisions than managers—is inapplicable to the tender offer context." *Id.* at 1746. Tender offers do not involve management decisions, thus the courts need not exercise business judgment to evaluate management. *Id.* Courts would be required only to determine whether the managers were, in fact, passive. *Id.*

90. Easterbrook & Fischel, *Takeover Bids*, *supra* note 89, at 1734-39.

91. *Id.* The authors argue that we have an efficient market in which companies sell stock for its current worth under existing management. *Id.*

92. See, e.g., Lipton, *A Response*, *supra* note 59, at 1232-33 ("economic benefits of takeovers are debatable").

93. See *id.* at 1235.

94. See, e.g., Lipton, *Takeover Bids*, *supra* note 11, at 115 (directors should consider long-term interests of shareholders in deciding to accept or reject tender offer); Steinbrink, *supra* note 77, at 891-92 (management is steward of shareholders' collective investment and must act on their behalf in context of takeover); cf. Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 267 (1983) (because tender offers are highly coercive, there is a substantial risk that shareholders would accept individually an offer they would reject collectively).

95. See *infra* notes 114-91 & accompanying text.

shareholders to determine the permissible degree of management involvement.

Professor Gilson has proposed legislation that is based on a distinction between defensive conduct in anticipation of a tender offer and defensive conduct during the course of a tender offer.⁹⁶ Gilson's proposal circumscribes management's tactics only during a tender offer. Professor Gilson argues that "the tender offer is the only displacement mechanism which has the potential to effectuate"⁹⁷ some constraint on management's self-dealing.⁹⁸ Thus, he contends that defensive tactics during a tender offer should be banned⁹⁹ so that offerors have unrestricted access to target shareholders.¹⁰⁰ Professor Gilson would bar defensive tactics only during a tender offer, however, because "pre-offer tactics are simply less likely to be effective"¹⁰¹ and, in any event, can be regulated by traditional fiduciary standards.¹⁰²

To illustrate the ineffectiveness of pre-offer defenses, Professor Gilson discusses the defensive tactic of buying a company in the same line of business as the offeror's business to create an antitrust barrier to the takeover. He argues that this defensive tactic is ineffective in the pre-offer period when the offeror's identity and line of business are unknown.¹⁰³ Moreover, Professor Gilson claims that diversification solely to create antitrust barriers to *any* would-be raider is a poor business practice likely to produce a decreased stock price and to render the company a more attractive target.¹⁰⁴

Although Professor Gilson is correct in the case of the antitrust barrier defense, the deficiency of his pre-offer versus post-offer distinction is apparent if the inquiry is expanded to other pre-offer tactics. Some pre-offer tactics may be as effective defense weapons as some post-offer tactics. For example, if management, prior to a tender offer, sells a large block of stock to someone friendly to management with the understanding that the block will not be tendered in a hostile tender offer, the tender offer will encounter difficulty. Moreover, this strategy is effective

96. See Gilson, *supra* note 65, at 887 (target management's conduct should be limited after learning of existence of tender offer).

97. *Id.* at 844.

98. Management, because of its veto power, is not constrained in mergers and sales of assets. Similarly, proxy contests, because they are economically unattractive to challengers, do not effectively prevent management self-dealing. *Id.* at 843-44 & n.95.

99. *Id.* at 846.

100. *Id.* at 845.

101. *Id.* at 888.

102. *Id.* at 890.

103. *Id.* at 888.

104. *Id.*

whether taken prior to or after a tender offer. Thus, although Professor Gilson seeks to protect shareholders from abusive defensive tactics, the pre-offer/post-offer distinction fails to achieve adequate protection.

Professor Lowenstein has offered a third legislative proposal that would amend the Williams Act to require that hostile takeover bids remain open for at least six months.¹⁰⁵ Professor Lowenstein proposes that during this period the target should be barred from undertaking any structural change without the approval of at least a majority of the target's shares.¹⁰⁶ Generally, this proposal would cover transactions that significantly affect corporate assets, capital structure, or voting rights.¹⁰⁷

Two aspects of Professor Lowenstein's proposal, namely, the requirements for shareholder approval of defensive tactics and a longer duration for tender offers bids, are sound. Professor Lowenstein's proposal is objectionable, however, because he seeks to regulate only post-offer defensive tactics¹⁰⁸ and would achieve that result through the federal law,¹⁰⁹ thus pre-empting state law efforts at regulation. Although he concedes that "any federal scheme by which target boards of directors are forced to submit for shareholder approval matters ordinarily authorized by board action alone must have some impact on state authority,"¹¹⁰

105. Lowenstein, *supra* note 94, at 317-18, 322-23 (discussing need for open offer period to allow a shareholder vote). The Williams Act, Pub. L. No. 90-439, § 2, 82 Stat. 454 (1968), added §§ 13(d)-(e), 14(d)-(f) to the Securities Exchange Act of 1934 (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1981 & Supp. 1984)). Currently, SEC regulations require tender offers, with limited exceptions, to remain open for 20 business days. 17 C.F.R. § 240.14e-1 (1984).

106. Lowenstein, *supra* note 94, at 317.

107. Professor Lowenstein defines "structural change" as

(a) any acquisition or disposition of any significant amount of assets otherwise than in the ordinary course of business, any issuance or repurchase of 5% or more of any class of equity securities, or any agreement or arrangement for any of the foregoing, or (b) any other transaction or action whether or not comprehended by clause (a) which, under such rules as the [Securities Exchange] Commission shall prescribe, shall be deemed reasonably likely to affect significantly any of the following: (i) the business or assets of the company, (ii) the financial condition or capital structure of the company, or (iii) the voting rights of any class of securities of the company

Id. at 317-18.

108. Professor Lowenstein recognizes this criticism, but rejects relentless pursuit of defensive tactics because federal regulation of all defensive tactics would "intrude too deeply into areas traditionally reserved to the states." *Id.* at 322.

109. Professor Lowenstein argues that his proposal would not be the first to infuse substantive—rather than purely disclosure—issues into the Williams Act. *Id.* at 321. His proposal is objectionable not because it imposes substance, but rather because that substance—requiring a shareholder vote—is a state matter. See also *ABA Votes Against Federal Corporate Legislation*, Legal Times, Feb. 25, 1985, at 4, col. 1 (rejecting Congress' attempts to "federalize" state corporation laws).

110. Lowenstein, *supra* note 94, at 322.

he justifies this intrusion into state law because he perceives a futility in regulating defensive tactics on a state-by-state basis.¹¹¹

To the extent that tender offers affect interstate commerce, regulation at the federal level is justifiable.¹¹² Although interstate commerce is affected, much of the tender offer process is actually a state matter. For example, states historically have defined the rights of shareholders with respect to the corporation as well as with respect to their stock; state law delineates those transactions that require a shareholder vote, as well as management's role in such transactions. Thus, federal law requiring a shareholder vote to authorize defensive tactics would be an unwarranted, and perhaps unprecedented,¹¹³ intrusion into state corporate governance. Although state regulation is likely to result in less uniformity than federal regulation, variation in state corporate laws is an accepted norm. Lack of uniformity among state laws is not tantamount to futility or inefficiency.

In summary, the deficiencies of the business judgment rule and the fairness test have encouraged some legal scholars to propose legislation to police management conduct in defending against tender offers. These proposals either lack adequate safeguards for shareholders or challenge the traditional notion that corporate governance is within the purview of the states. The necessity for legislative action to protect shareholders in this relatively new, but important, area is, however, gaining acceptance.

A Lesson from the Law of Freeze-Out Mergers

Current law regarding freeze-out mergers provides useful parameters for fashioning suitable tender offer legislation. The current deficiency of state tender offer law parallels in many respects the inchoate condition of the law of freeze-out mergers¹¹⁴ in the mid 1970's. The

111. *Id.*

112. *Edgar v. MITE Corp.*, 457 U.S. 624, 643-44 (1982) (holding state takeover statute an unconstitutional violation of the commerce clause).

113. Professor Lowenstein's other examples of federal intrusions into state governance are unpersuasive. He argues that the Investment Company Act limits the right of registered investment companies to pay dividends and issue senior securities, in addition to restricting the composition of the board. Lowenstein, *supra* note 94, at 321; *see* Investment Company Act, 15 U.S.C. §§ 80a-16, 80a-18 (1982). He also states that the Trust Indenture Act and the proxy rules of the Securities Exchange Act of 1934 contain provisions that relate to internal corporate governance. Lowenstein, *supra* note 94, at 321-22; *see* Trust Indenture Act of 1939, 53 Stat. 1149 (codified in part at 15 U.S.C. §§ 77aaa-77bbb (1982)); *see also* Securities Exchange Act of 1934, 15 U.S.C. § 78n (1982). The primary purpose of both the Trust Indenture Act and the proxy rules, however, is to regulate disclosure, a function that traditionally falls within the scope of federal legislation.

114. In a freeze-out merger, the controlling shareholders of a corporation typically form a

evolution of the law regulating freeze-out mergers may be instructive in developing standards to govern target management's defensive tactics.

The Analogy Between Freeze-Out Merger Regulation and Tender Offer Regulation

Corporate management can conduct freeze-out mergers and tender offer defenses entirely within the letter of the merger provisions of the state corporate statutes.¹¹⁵ In the early freeze-out cases, courts generally took refuge in these statutes and held in favor of the controlling shareholders when they had fulfilled the statutory requirements.¹¹⁶ Neither courts nor state legislatures distinguished freeze-out mergers from traditional mergers,¹¹⁷ despite management's self-interest in a freeze-out

new corporation, contribute their stock for all shares in the newly formed corporation, and vote to merge the two corporations. The terms of the merger, controlled by the majority, provide that equity shares in the original corporation will be exchanged for cash or nonequity instruments. In this way minority shareholders are forced out of their equity positions and management strengthens its hand. "Going private" is a subset of freeze-out mergers in which a public corporation reverts to private status as a result of the freeze-out's elimination of the public shareholders. Another kind of freeze-out that is gaining tremendous popularity is the leveraged buyout. A leveraged buyout is a transaction in which borrowings are used to fund all or a large part of the purchase price of a business; a relatively small portion of the purchase price is funded by equity. *See Frome & Getzoff, Structuring the Buyout*, in HANDBOOK OF MERGERS, ACQUISITIONS AND BUYOUTS 517 (Lee & Coleman eds. 1981). When used as a defensive tactic, the target's principal shareholders or a "white knight" buys out the target. Other common methods of effectuating a freeze-out are a tender offer followed by a cash-out merger, and a cash-out merger between a parent and its subsidiary. For a discussion of the various techniques to effectuate a freeze-out, see Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987 (1974).

115. The merger and appraisal sections of the corporate statute will govern these transactions. *See, e.g.*, CAL. CORP. CODE §§ 1100, 1110, 1300 (West 1977 & Supp. 1984); DEL. CODE ANN. tit. 8, §§ 251, 253, 262 (1983); N.Y. BUS. CORP. LAW §§ 901, 905, 910 (McKinney 1963 & Supp. 1983-1984).

116. *See, e.g.*, *Coyne v. Park & Tilford Distillers Corp.*, 38 Del. Ch. 514, 520, 154 A.2d 893, 897 (1959) (short-form merger statute empowers parent to cash-out minority stockholders); *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30, 35 (Del. Ch. 1971) (no preliminary injunction absent showing of unfairness in long-form merger); *Bruce v. E.L. Bruce Co.*, 40 Del. Ch. 80, 82, 174 A.2d 29, 30 (1961) (absent fraud or unfairness, court's policy is to permit corporations to take advantage of statutory device for consolidation). *But see* *David J. Greene & Co. v. Dunhill Int'l, Inc.*, 249 A.2d 427, 431 (Del. Ch. 1968) (directors have burden to show fairness of long-form merger where directors are on both sides).

117. The availability of appraisal rights for dissenting shareholders in a merger also encouraged the courts to take a hands-off policy with freeze-outs. *See, e.g.*, *Yanow v. Teal Indus., Inc.*, 178 Conn. 262, 278, 422 A.2d 311, 317 (1979) (appraisal rights exclusive remedy for dissenters under short-form merger statute); *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30, 35 (Del. Ch. 1971) (minority's only recourse is appraisal); *Pupecki v. James Madison Corp.*, 376 Mass. 212, 216, 382 N.E. 2d 1030, 1033 (1978) (appraisal exclusive remedy unless plaintiff shows fraud).

Most statutes provide that appraisal rights are a dissenting shareholder's exclusive remedy unless the shareholder can prove that the corporate action was fraudulent with regard to the

merger. In traditional mergers, target management negotiates at arms' length with the management of an unrelated corporation. In a freeze-out merger, however, management essentially deals with itself because the majority shareholders usually represent management; thus, management is on both sides of the transaction. Moreover, in a freeze-out merger the majority shareholders decide when, and on what terms, the minority shareholders will be expelled from the corporation, leaving the majority shareholders as the sole owners of the corporate assets. As long as the freeze-out merger met the statute's merger requirements, however, state courts did not further regulate the freeze-out and management's self-dealing went unchecked.

Frustrated by the state courts' hands-off approach, minority shareholders turned to the federal courts for relief. Plaintiffs claimed that the freeze-out mergers, and the consequent undervaluation of their shares, violated the antifraud provision of the federal securities laws.¹¹⁸ At first, plaintiffs met with some success.¹¹⁹ In *Santa Fe Industries, Inc. v. Green*,¹²⁰ however, the United States Supreme Court held that absent fraud, a freeze-out merger accompanied by full disclosure did not fall within the parameters of the federal securities laws.¹²¹ Thus, minority shareholders had no recourse but the state courts.

Corporate managers, therefore, were immune from federal liability, if they made a full disclosure, and relatively safe from state liability, if they followed the requirements of the merger statutes. This attitude,

complaining shareholder. See, e.g., MODEL BUSINESS CORP. ACT § 80 (1979); MASS. GEN. LAWS ANN. ch. 156B, § 98 (West 1970 & Supp. 1984-1985); N.Y. BUS. CORP. LAW § 623 (McKinney 1963 & Supp. 1983-1984).

More recently, however, some state courts have held that shareholders dissenting in freeze-out mergers are entitled to equitable remedies in addition to appraisal. See *infra* notes 125-32 & accompanying text; see also *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032, 1034 (Del. 1979) (majority shareholders' fiduciary duty to minority shareholders in freeze-out not satisfied by appraisal rights); *Gabhart v. Gabhart*, 267 Ind. 370, 388, 370 N.E.2d 345, 356 (1977) (shareholder not limited to appraisal in dissolution).

118. Plaintiffs in the early freeze-out merger cases sued under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1984), which was promulgated pursuant to § 10(b) of the Securities Exchange Act of 1934. See 15 U.S.C. § 78j(b) (1982). Section 10(b) prohibits the use of fraudulent, deceptive, or manipulative acts in connection with the purchase or sale of securities. *Id.* Plaintiffs also asserted that the inherent unfairness of going private transactions fell within the proscriptions of Rule 10b-5.

119. *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283 (2d Cir. 1976) (complaint by minority shareholders against majority shareholders for breach of fiduciary duty in short-form merger redressable under 10(b)), *rev'd*, 430 U.S. 462 (1977); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974) (cause of action stated under Rule 10b-5 by minority shareholder who was forced to sell shares in merger), *cert. denied*, 421 U.S. 976 (1975).

120. 430 U.S. 462 (1977).

121. *Id.* at 473.

coupled with market conditions supporting going private transactions,¹²² encouraged the proliferation of freeze-out mergers. Scholars criticized this trend, charging that freeze-outs abused shareholders' rights and were economically inefficient.¹²³ Some scholars urged Congress to enact a federal corporate law that would ensure more protection of minority shareholders' rights than did the state courts and legislatures.¹²⁴ With no legislative response forthcoming at the federal or state level, however, the state courts were pressured to take some action.

In 1977, the Delaware Supreme Court responded boldly in *Singer v. Magnavox Corp.*,¹²⁵ holding that mere compliance with the merger statute would no longer validate a freeze-out merger. The Delaware Supreme Court required the majority shareholders to satisfy their fiduciary duty to the minority shareholders¹²⁶ by establishing a business purpose for the freeze-out.¹²⁷ Moreover, the court required the majority shareholders to bear the burden of proving that the freeze-out was entirely fair to the minority shareholders.¹²⁸

Singer was significant because the Delaware Supreme Court afforded minority shareholders some protection by imposing affirmative

122. In the mid 1970's, stock prices dropped, making it attractive for insiders to cause the corporation to repurchase the public's shares at depressed values.

123. See, e.g., Borden, *supra* note 114, at 988-89 (it is "particularly invidious" to use public-contributed equity to repurchase public shares); Brudney, *A Note On "Going Private,"* 61 VA. L. REV. 1019, 1028 (1975) (contrived merger that affects solely internal rearrangements defeats any prospect of efficiency gains); Sommer, "Going Private": *A Lesson in Corporate Responsibility*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,010 (Nov. 20, 1974); Note, *Going Private*, 84 YALE L.J. 903, 906 (1975) (going private enriches insiders at investing public's expense).

124. See, e.g., Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700-03 (1974) (remedy for "Delaware syndrome" requires federal standards of corporate responsibility); Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 1021 (1976) (further federalizing of corporate law only alternative to states' failure to control management); Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883, 884 (1976) (a national corporation act would afford greater recognition of fiduciary responsibility and protection of minority shareholders); Schwartz, *Regulating—Federal Chartering of Corporations: An Introduction*, 61 GEO. L.J. 71 (1972) (outlining basis for federal incorporation legislation); Young, *Federal Corporate Law, Federalism and the Federal Courts*, 41 LAW & CONTEMP. PROBS., Summer 1977, at 146, 150 (current state-oriented system regulating national corporations is backward). But see Arsht, *Reply to Professor Cary*, 31 BUS. LAW. 1113, 1114-18 (1976) (Delaware corporation law provides an effective and inexpensive means of redress for any aggrieved stockholder); Manning, *Thinking Straight About Corporate Law Reform*, 41 LAW & CONTEMP. PROBS., Summer 1977, at 3, 15-19 (Model Corporation Act would stunt the healthy evolution of state corporation laws).

125. 380 A.2d 969 (Del. 1977).

126. *Id.* at 980.

127. *Id.*

128. *Id.* at 976 (citing *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 298, 93 A.2d 107, 109 (1952)).

duties on management.¹²⁹ The progress in *Singer* was quickly eroded, however, by a subsequent decision undercutting the business purpose requirement. In *Tanzer v. International General Industries, Inc.*,¹³⁰ the Delaware Supreme Court held that the business purpose requirement was satisfied even if the business purpose served only the interests of the majority shareholders.¹³¹ Nevertheless, the Delaware courts adhered to *Singer*'s fairness requirement and held that it could be satisfied by a fair vote of a majority of the minority shareholders because management would no longer be dealing only with itself.¹³² Thus, despite the dilution of the business purpose prong of the *Singer* requirements, the fairness prong afforded minority shareholders some protection.

The Weinberger Standard: Fairness

After six years of the *Singer* principles and more than twenty years of experience with freeze-out mergers, the Delaware Supreme Court, in *Weinberger v. UOP, Inc.*,¹³³ articulated a new standard for freeze-out mergers. Reversing in part its position in *Singer*, the Delaware Supreme Court held that freeze-out mergers need not have a valid business purpose.¹³⁴ Instead, under *Weinberger*, if freeze-out mergers involve a conflict of interest,¹³⁵ defendants must establish "their utmost good faith and

129. In *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032 (Del. 1979), the Delaware Supreme Court held that the fiduciary requirements of *Singer*, which involved a long-form squeeze-out merger, were equally applicable to short-form squeeze-out mergers. *Id.* at 1036. Compare DEL. CODE ANN. tit. 8, § 251 (1983) (long-form merger provision) with *id.* § 253 (short-form parent subsidiary merger provision).

130. 379 A.2d 1121 (Del. 1977).

131. *Id.* at 1123. The court held that the benefit of facilitated long-term debt financing that would accrue to the parent as a result of the merger was a bona fide business purpose. *Id.* at 1125; see also *Dower v. Mosser Indus., Inc.*, 648 F.2d 183, 189 (3d Cir. 1981) (majority shareholders were reluctant to guarantee corporation's debt incurred to finance expansion; merger to facilitate financing constituted a proper business purpose); *Field v. Allyn*, 457 A.2d 1089, 1101 (Del. 1983) (elimination of minority shareholders in order to provide assurance that corporation could honor financial commitments was proper business purpose); *Young v. Valhi, Inc.*, 382 A.2d 1372, 1377 (Del. 1978) (tax savings achievable by other means and elimination of tenuous potential conflicts of interest not a valid business purpose for merger).

132. See, e.g., *Harman v. Masoneilan Int'l, Inc.*, 442 A.2d 487, 495 (Del. 1982) (allegation by plaintiff that majority vote of minority shareholders was coerced states a cause of action); *Weinberger v. UOP, Inc.*, 426 A.2d 1333, 1346 (Del. 1981) (where merger requires approval of majority of minority shareholders, majority has burden to prove fairness), *rev'd and remanded*, 457 A.2d 701, 703 (Del. 1983) (corporate action approved by majority of minority shareholders shifts burden to minority to show unfairness).

133. 457 A.2d 701 (Del. 1983).

134. *Id.* at 715.

135. The court said, "[t]he result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at

the most scrupulous inherent fairness" of the transaction.¹³⁶ The court focused on two aspects of fairness: fair dealing¹³⁷ and a fair price for the minority shareholders.¹³⁸

In *Weinberger*, the lower court had held that the freeze-out was fair because it had been approved by a majority of the minority shareholders.¹³⁹ The Delaware Supreme Court disputed this conclusion because it found deficiencies in the manner in which the majority, Signal Corporation, conducted the freeze-out. The most flagrant violation was the failure of two interested directors to disclose fully all relevant facts to the other directors, the officers, and the minority shareholders.¹⁴⁰ The court held that "[u]nder the circumstances, an approval by a majority of the minority [shareholders] was meaningless."¹⁴¹ In addition, the court viewed skeptically the hurried timeframe in which the transaction evolved,¹⁴² as well as the virtual lack of negotiations between the managements of the parent and subsidiary.¹⁴³

The court in *Weinberger* placed the burden of proving fraud or unfairness on the plaintiffs if the freeze-out was approved by an informed vote of the minority shareholders.¹⁴⁴ If the plaintiffs could demonstrate specific acts of fraud, misrepresentation, or other misconduct indicating unfairness, the burden then shifted to the defendants to show, by a preponderance of the evidence, that the entire freeze-out transaction was fair.¹⁴⁵ The net result was that if minority shareholders had the burden of proof and could not allege specific acts of fraud, misrepresentation, or other misconduct, then their sole remedy was through the statutory appraisal process as modified by *Weinberger*.¹⁴⁶

arm's length." *Id.* at 709 n.7. The court found, however, that Signal had done nothing to attempt to structure the transaction on an arm's length basis. *Id.* at 710.

136. *Id.*

137. Fair dealing, the Court explained, "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." *Id.* at 711.

138. *Id.*

139. *Id.* at 715.

140. A feasibility study by two interlocking directors indicated that the purchase of the minority interest at \$21-24 per share would have been a good investment by the parent. The study was not disclosed to the other directors, to the officers, or to the minority shareholders of the subsidiary, and the merger price per share was \$21. *Id.* at 708.

141. *Id.* at 712.

142. *Id.* at 711.

143. *Id.*

144. *Id.* at 703.

145. *Id.* After *Weinberger*, the burden of proof in a freeze-out is the same as in any other conflict of interest transaction under the Delaware statute.

146. Prior to *Weinberger*, Delaware courts employed the "Delaware block" or "weighted average" method to appraise the value of minority shareholders' stock. *See, e.g., Heller v.*

Thus, *Weinberger* facilitated the process of ensuring that a freeze-out will not be challenged. All management has to do is meet the *Weinberger* requirements of fair dealing and fair price. The criteria for fair dealing, and thus for deflecting a challenge to a freeze-out, include a fairness opinion from an investment banker; approval by informed, independent directors of the corporation; and ratification, based on all material facts, by the corporation's unaffiliated shareholders.¹⁴⁷ Once

Munsingwear, Inc., 33 Del. Ch. 593, 596, 98 A.2d 774, 777 (1953); *In re General Realty & Utils. Corp.*, 29 Del. Ch. 480, 497, 52 A.2d 6, 14 (1947). Courts most frequently considered market value of the shares, net asset value of the corporation, and the earnings value. For a discussion of the factors and the considerations in assigning values to them, see Comment, *Valuation of the Dissenters' Stock Under Appraisal Statutes*, 79 HARV. L. REV. 1453, 1456-71 (1966); see also *Piemonte v. New Boston Garden Corp.*, 377 Mass. 719, 723-24, 387 N.E.2d 1145, 1148-50 (1979) (discussing "Delaware block" approach valuation).

In *Weinberger*, the court, cautioning that the fairness test was not "bifurcated . . . between fair dealing and fair price," nevertheless emphasized that if fraud is a factor, "price may be the preponderant consideration outweighing other features of the merger." *Weinberger*, 457 A.2d at 712. Thus, valuation is a critical issue. Rejecting the prior method of valuation, the court held that the appropriate method of valuation required consideration of all relevant factors affecting price. *Id.* at 713-14; see DEL. CODE ANN. tit. 8, § 262 (1975 & Supp. 1982); see also Note, *Weinberger v. UOP, Inc.*, 5 WHITTIER L. REV. 661, 668-70 (1983) (discussing change in appraisal method).

Weinberger thus offers management two alternatives to avoid a challenge to a freeze-out merger. First, management need not obtain a fair vote of the minority shareholders if it can prove the fairness of the transaction. Alternatively, management can obtain a fair vote of the shareholders. If a fair vote is taken, the minority shareholders have the onerous burden of showing that the freeze-out was illegal by proving specific acts of fraud and unfairness; if they cannot prove fraud, misrepresentation, or other misconduct, their sole remedy is through the statutory appraisal process.

147. *Contra* Longstreth, *Fairness of Management Buyouts Needs Evaluation*, Legal Times, Oct. 10, 1983, at 15, col. 1. [hereinafter cited as Longstreth, *Fairness*]. Former SEC Commissioner Longstreth has denounced the ability of each of these three devices to ensure inherent fairness for minority shareholders. He has contended that an investment banker's fairness opinion is deficient because the range of fairness considerations is too broad from which to extract a meaningful opinion, and because the investment banker is seldom able to consider all relevant facts. *Id.* at 19-20. He also has argued that there may be economic pressures on the banker to support management's position. *Id.* at 20; see also *Weinberger v. UOP, Inc.*, 426 A.2d 1333, 1338-39 (Del. Ch. 1981) (finding circumstances surrounding appraisal for fairness questionable), *rev'd and remanded on other grounds*, 457 A.2d 701 (Del. 1983); *Tanzer v. International Gen. Indus., Inc.*, 402 A.2d 382, 391 (Del. Ch. 1979) (on remand) (questioning independence of appraiser).

Commissioner Longstreth further has argued that the independent directors' approval is defective because they invariably have some business or personal connection with the corporation's management. Longstreth, *Fairness*, *supra*, at 20, col. 1. Furthermore, he has contended that the business judgment rule and the fairness concept are too broadly construed to ensure any substantive protection for the minority shareholders. *Id.*

Finally, Commissioner Longstreth believes that ratification by unaffiliated shareholders does not protect those shareholders because they are not in a position to evaluate the terms of the transaction and they have no viable option if they reject the deal. *Id.* at col. 2; see also Chazen, *Fairness from a Financial Point of View in Acquisitions of Public Companies: Is*

these requirements are met, the minority shareholders' challenge to a fair price will be addressed in the appraisal proceedings.

While *Singer* was significant for its recognition of the conflict of interest problem, the significance of the *Weinberger* decision is the implication that a fairness standard can best address management's conflicts of interest inherent in a freeze-out. The court in *Weinberger* suggested that management may employ one of two alternatives to establish fairness. On the one hand, management may put the transaction to the shareholders for a vote. If management chooses this route and the stockholders approve the transaction, the minority shareholders who challenge the freeze-out will then have the onerous burden of proving fraud, misrepresentation, or other unfairness. On the other hand, management may forego a shareholder vote, but then must prove the fairness of the freeze-out.

Given the difficulty of proving the fairness of a freeze-out, management is unlikely to opt for this burden and therefore will submit the transaction to a vote of the shareholders. The court encouraged management to give the shareholders who have no conflict the opportunity to vote on the transaction,¹⁴⁸ an alternative that has many advantages. First, a vote of the disinterested shareholders eliminates the necessity for judicial evaluation of whether management's conflict of interest tainted its decision. Any management self-dealing is effectively eliminated when the minority shareholders have the power to abort the transaction. Second, a fair vote of shareholders is an objective criterion that replaces judicial evaluation of management's motives. Third, objectivity allows management to know what is required of them and how to avoid litigation. Finally, because voting enables the disinterested shareholders to thwart the transaction, better policing of management's self-dealing is possible. If management chooses to obtain the approval of the shareholders who will be frozen out, it is in management's interest to make the deal sufficiently attractive in order to obtain the required approval.¹⁴⁹

"Third-Party Sale Value" the Appropriate Standard?, 36 BUS. LAW. 1439, 1475 (1981) (arguing that shareholder vote cannot ensure fairness).

Thus, Commissioner Longstreth has contended that use of these three devices "will typically assure that management's self-dealing is measured, for all practical purposes, not by the rule of inherent fairness, but by the remarkably elastic rule of business judgment." Longstreth, *Fairness*, *supra*, at 20, col. 2.

148. *Weinberger*, 457 A.2d at 703.

149. Three principal arguments against the utility of shareholder approval exist. First, shareholders often just follow management's recommendations. Second, shareholders may accept management's proposal simply because there is no one representing the shareholders to negotiate for a higher price. Third, a shareholder vote is not dispositive of fairness and may deprive the minority of the fiduciary protections to which it is entitled under *Singer*. Weiss,

In summary, the evolution of the law of freeze-out mergers reveals the lesson the courts have learned about policing self-dealing transactions: approval by disinterested shareholders can resolve issues presented by management's inherent conflict of interest. This Commentary now applies this lesson in the tender offer context.

Parallels to the Defensive Tactics Issue

The conflict of interest in management's tender offer defensive tactics is similar to management's conflict of interest in freeze-out mergers. Both transactions allow management to favor itself over the shareholders. Moreover, both transactions enable management to dictate the investment decisions of the corporation's shareholders. In a freeze-out, for example, management decides when and at what price the minority will sell. Similarly, in a hostile tender offer, management's defensive tactics can preclude shareholders from selling their stock at the offered premium.

The current law governing defensive tactics is similar to the law of freeze-out mergers in the mid 1970's. Like the freeze-out mergers then, the defensive-tactic transactions now are treated by the state courts as ordinary business transactions, regulated only by traditional statutory and common law. Moreover, the current state court decisions on defensive tactics reflect the rigidity that once characterized the state court decisions on freeze-out mergers when the courts lacked a feasible alternative; in the old freeze-out cases, as well as in the current defensive tactics cases, the courts attempted to treat the transactions according to the statutory and common law norm. Eventually, courts recognized that freeze-outs are not ordinary mergers because they involve management in an inherent conflict of interest. Recognition of the management conflict of interest is now similarly due for defensive tactics. In the section that follows, a legislative solution, similar to the *Weinberger* scheme, is proposed for the conflicts wrought by defensive tactics.

A Legislative Proposal

Part II demonstrated the deficiencies of the current judicial evaluation of tender offer defensive tactics. Application of the business judgment rule in this context is of little utility and, in fact, has permitted corporate managers to adopt defensive tactics without adequately scrutinizing their benefit to the target shareholders. The courts, if left to their

The Law of Take Out Mergers: A Historical Perspective, 56 N.Y.U. L. REV. 624, 676-77 (1981); see also *supra* note 147.

own devices, might discard the business judgment rule in favor of a standard that addresses more directly the conflict of interest inherent in defensive tactics. Courts have given no indication, however, that they will move toward such an approach. Furthermore, such policy decisions are more appropriately left to the legislatures. A legislative alternative, therefore, is the most desirable resolution to this problem.

A Proposed Amendment to the Model Business Corporation Act (MBCA)

It is proposed that the Model Business Corporation Act (MBCA), be amended to provide the following:

- (a) The board of directors of any corporation that desires to take any action (as defined in part (c)) to make its corporation less attractive as an actual or potential target of a tender offer shall:
 - (1) adopt a resolution approving such action;
 - (2) prepare a disclosure statement outlining the terms and conditions of the proposed action, the method of carrying the same into effect, the effect on the corporation and its shareholders from carrying the same into effect, and any other material information regarding the proposed action;
 - (3) submit such disclosure to the shareholders with notice for the meeting required pursuant to (a)(4); and
 - (4) submit such proposed action to a vote of the shareholders at an annual or special meeting called for the purpose of voting on the proposed action.
- (b) No such action shall be taken until it has been approved by — percentage of the outstanding shares of the corporation, considered as a single class, entitled to vote generally in the election of directors. Notice for the meeting shall be the same as for any other annual or special meeting.
- (c) For these purposes, “action” requiring compliance with subsections (a) and (b) shall include any change to the business or financial or capital structure of the corporation designed to render the corporation less attractive as an actual or potential target of a tender offer. “Action” shall not include payments made to or for consultation with any legal, investment, accounting or other advisor about a contemplated action or any actual or potential tender offer.

Conceptual Underpinnings of the Proposal

This proposal involves three key features: (1) the absence of any evaluation of the inherent worth of either tender offers or defensive tactics; (2) the notion that the necessary method for dealing with defensive tactics should lie with the shareholders; and (3) the use of state, rather than federal, law to implement the shareholder action.

The proposal presumes no evaluation of tender offers and defensive

tactics as beneficial or detrimental business transactions.¹⁵⁰ Rather than challenging the current environment, in which tender offers are accepted business transactions that operate primarily within the confines of the Williams Act,¹⁵¹ the proposal attempts to regulate the inherent conflict of interest that management faces when confronted by a hostile tender offer.

Second, the proposal is premised on the assumption that with proper disclosure of all relevant information, shareholders can make competent decisions regarding corporate matters affecting their interests.¹⁵² The lesson learned from the judicial treatment of freeze-out mergers is that an acceptable method of deflecting management's conflict of interest in areas affecting shareholders is to put the proposed transaction to a vote of the shareholders. The logic is even more compelling in the hostile tender offer context because defensive tactics can preclude, rather than merely dictate the terms of, the shareholders' sale of their stock.

Additionally, shareholder action can be meaningful only if management adequately discloses the impact of its proposed defensive tactics. Because the business judgment rule inadequately monitors defensive tactics, management has long been able to make decisions regarding defensive tactics without contemporaneous shareholder knowledge and review. By introducing a disclosure element into the decision-making process, the proposal forces management to evaluate carefully its conflict of interest before proceeding with a particular defensive tactic.¹⁵³

150. Others, including Congress, have made this evaluation and generally have concluded that, at a minimum, tender offers can be beneficial to corporations, target shareholders, and the economy. See *Edgar v. MITE Corp.*, 457 U.S. 624, 633 n.9 (1982) (Congress did not want to deny shareholders opportunity of selling shares at premium in tender offer) (quoting 113 CONG. REC. 24666 (1967) (remarks of Sen. Javits)).

151. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982)) (amending Securities Exchange Act of 1934, ch. 404, 48 Stat. 894 (1934)). Tender offers also operate within the confines of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, Pub. L. No. 94-435, 90 Stat. 1397 (codified at 15 U.S.C. § 12 (1982)), and various state tender offer statutes. The constitutionality of many state statutes, however, are in doubt after the Supreme Court's opinion in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982). In *MITE*, the Supreme Court held unconstitutional the Illinois Business Take-Over Act, ILL. REV. STAT. ch. 121 1/2, § 137.51 (1979). See *infra* note 163.

152. Some argue that shareholders do not take their franchise seriously. See *supra* note 149. Such arguments serve as predicates for judicial and legislative interference in shareholders' investment decisions under the guise of investor protection. Investors, however, when armed with full and fair disclosure by management, are the best protectors of their own interests. See also M. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 37-63 (1976); Lowenstein, *supra* note 94, at 257-68 (discussing role of shareholder in tender offers).

153. Part of Congress' motive for enacting the disclosure provisions of the federal securities laws was to help police self-dealing transactions. See Douglas & Bates, *The Federal Secur-*

Furthermore, the proposal permits all shareholders, rather than just the disinterested shareholders, to vote. Members of management who own stock are not treated any differently from other target shareholders should the defensive tactic be approved or denied. The tender offer solution is thus distinct from the freeze-out transactions in which management and nonmanagement shareholders are treated dissimilarly, and is analogous to the procedure for organic changes, in which all shareholders of a class are treated identically and are permitted to vote.

Third, the proposal looks to state, rather than federal, law to implement the shareholder review process. Although the regulation of tender offers is a federal matter, the issue in defensive tactics, namely management's conflict of interest, involves fiduciary law, a matter traditionally relegated to the states. Furthermore, defensive tactics frequently involve matters of corporate governance, another area of state regulation. Consequently, the state corporate statutes are the most appropriate vehicle to address this problem.

In addition to the conceptual features, the proposal contains several practical elements. First, to encompass all of management's defensive tactics, the proposal employs a purposefully broad definition of management action. Second, the proposal permits each state to set the percentage of shares required for approval, just as each state currently fixes the percentage needed for organic changes. Third, the proposal deliberately leaves management free to obtain professional advice regarding tender offers or defensive tactics without first gaining shareholder approval. Because current federal law require target management to take a position regarding a tender offer, expenditures for professional advice are warranted without shareholder approval.¹⁵⁴ Finally, the proposal regulates both pre-offer and post-offer defensive tactics.

Critique of the Proposal

One problem implicit in the proposal is that target management's solicitation of shareholder approval for a proposed defensive tactic requires time. Although management theoretically could procure shareholder approval within the tender offer's current statutory minimum timeframe of twenty business days,¹⁵⁵ a lengthening of the minimum

ities Act of 1933, 43 YALE L.J. 171 (1933) (discussing unscrupulous transactions that gave rise to securities laws); James, *The Securities Act of 1933*, 32 MICH. L. REV. 624, 624-30 (1934) (discussing political environment prior to enactment of 1933 Act).

154. Moreover, management will have to seek outside expert advice to determine what, if any, proposal for defensive action they should place before the shareholders for a vote.

155. 17 C.F.R. § 240.14e-1(a) (1983). For example, Bendix Corporation was able to schedule a meeting of its stockholders only twenty-one days after Martin Marietta Corporation

timeframe under federal law may be necessary to implement this proposal.

What is an appropriate and realistic timeframe remains unclear. Various proposals have surfaced recently, recommending periods ranging from forty-four days¹⁵⁶ to six months.¹⁵⁷ The SEC is studying this question¹⁵⁸ and, along with Congress, is best equipped to decide the appropriate timeframe.

A second consideration is whether the states would adopt such a proposal. Although Congress desired to favor neither the bidder nor target management,¹⁵⁹ the states historically have struck a balance in favor of target management and its efforts to resist takeovers.¹⁶⁰ Thus, the states may be unwilling to regulate management's defensive tactics.

The states' disinclination to enact the proposed regulation can be addressed on two grounds. First, the subject of defensive tactics is topical, and the current pressure on Congress to respond, at least to the most flagrant defensive tactics, is substantial.¹⁶¹ If these tactics continue un-

began its offer. Lowenstein, *supra* note 94, at 322. Bendix was able to hold its meeting so quickly in part because the SEC processed the proxy material quickly, and the New York Stock Exchange waived compliance with its thirty day notice requirement. *Id.* Thus, it is not safe to assume that such meetings can occur with the same rapidity with which the Bendix meeting occurred.

156. The Tender Offer Advisory Committee recommended the timeframe be extended to forty-four days if the tender offer is for less than all the outstanding stock. The SEC rejected this proposal in part because it felt the recommendation reflected concerns about two-tiered bids that should be addressed directly. See *SEC Studies Two-Tier Pricing in Tender Offers*, FED. SEC. L. REP. (CCH) No. 1078 (June 27, 1984).

157. Lowenstein, *supra* note 94, at 317.

158. The Securities Exchange Commission has consistently rejected lengthy minimum offering periods. Recently the SEC rejected a proposal for a 30 day period saying that shareholders did not need that long a waiting period in which to make a decision. The SEC maintains that the timeframe should be established by rule to provide flexibility with rapid technological changes. See *SEC Voices Concern About Tender Offer Reform Act*, FED. SEC. L. REP. (CCH) No. 1090 (Jan. 1985).

159. See *Edgar v. MITE Corp.*, 457 U.S. 624, 633 (1982) (Congress enacted Williams Act to protect investors but sought to avoid favoring either target management or bidder); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 29 (1977) (Congress, in enacting Williams Act, was committed to neutrality in contests for control).

160. For example, several states gave management the advantage by requiring time delays or time consuming hearings. See, e.g., CONN. GEN. STAT. ANN. § 36-460 (West Supp. 1984) (allowing management to request a hearing); OHIO REV. CODE ANN. § 1707.041(B)(1) (Page Supp. 1980) (required 20 day precommencement waiting period); PA. STAT. ANN. tit. 70, § 74(a) (Purdon Supp. 1980) (20 day period between offer and purchase of securities required); see also Sargent, *On the Validity of State Takeover Regulation: State Responses to MITE and Kidwell*, 42 OHIO ST. L.J. 689, 694 (1981) (state regulations tilt balance sought in Williams Act toward incumbent management).

161. For example, Congress held hearings in response to the Bendix-Martin Marietta takeover. Moreover, the SEC established a Tender Offer Advisory Committee, which recently sent

checked by state law, Congress is likely to act and thereby to encroach upon the traditionally state-regulated area of corporate governance. State legislatures seeking to avoid such federal encroachment must act first. Second, the proposal is tailored to allow each state to choose the degree to which it will regulate defensive tactics. Although the mechanism for regulation in each state would be identical—disclosure and a shareholder vote prior to adoption of any defensive tactic—each state will set the required percentage for approval. Management in State A needing only a 51% vote to approve its proposed tactics would be significantly less constrained than management in State B needing an 80% vote. The ability to tailor the proposal to accommodate the state's evaluation of the defensive tactics problem should make the proposal more palatable.

Finally, the proposal must overcome potential constitutional problems. In *Edgar v. MITE Corp.*,¹⁶² a majority of the United States Supreme Court held that the Illinois Business Takeover Act violated the Commerce Clause.¹⁶³ A plurality of the Court also held that the Williams Act pre-empted the state statute.¹⁶⁴ Thus, all state statutes that affect tender offers must be reviewed for compliance with *MITE*.

The legislation proposed in this Commentary is distinguishable from the legislation invalidated in *MITE*. The aspect of the Illinois Act that the Court in *MITE* found violative of the Commerce Clause was the Act's broad regulation of securities transactions on a nationwide level.¹⁶⁵

proposed legislation to Congress recommending, among other things: 1) the prohibition of an issuer from repurchasing its own stock during a tender offer; 2) the requirement of majority approval before a company can issue new securities or more than 5% of a class of securities already outstanding; 3) the prohibition of an issuer from purchasing its securities from a person who holds a specified percentage for less than two years; and 4) the closing of the 10 day window period for Schedule 13D filings. See *SEC To Send Congress Tender Offer Reform Legislation*, FED. SEC. L. REP. (CCH) No. 1072 (May 16, 1984); see also H.R. 5693, 98th Cong., 2d Sess. (1984); *supra* note 88.

162. 457 U.S. 624 (1982).

163. U.S. CONST. art. I, § 8, cl. 3; see *MITE*, 457 U.S. at 646. The majority opinion concluded that the burdens imposed on interstate commerce by the Illinois Act were excessive in light of the local interests sought to be served. *Id.* Although Illinois argued that the statute was designed to protect resident shareholders, the Court found the statute affected more than just the Illinois shareholders by preventing nonresident shareholders from tendering their stock. *Id.* at 643.

164. *MITE*, 457 U.S. at 634. Because the majority disposed of the case on commerce clause grounds, it did not reach the pre-emption issue. Three justices, however, concluded that the Illinois Act was pre-empted by the Williams Act because its pro-target management provisions interfered with the federal statute's express policy of "neutrality" and "evenhandedness." *Id.* at 633; see also *Piper v. Chris-Craft Indus., Inc.* 430 U.S. 1, 29-30 (1977) (discussing congressional intent in enacting Williams Act to be neutrality and evenhandedness).

165. *MITE*, 457 U.S. at 643.

The Illinois Act was a regulatory roadblock preventing shareholders from tendering their stock. The legislation proposed here, however, neither regulates securities transactions on a nationwide level nor prevents shareholders from tendering any shares. To the contrary, the proposed legislation removes target management's ability to prevent the shareholders from tendering their stock unless the shareholders approve management's proposed defensive tactic. Moreover, the proposed legislation mirrors the Court's conclusion that tender offers are merely stock transfers and, as such, should not be hindered.¹⁶⁶ Because the proposed legislation does not impose any burdens on interstate commerce, it does not violate the Commerce Clause.

Arguably, the more difficult question about the proposal's constitutionality is whether the Williams Act pre-empts it.¹⁶⁷ Although the Court previously has applied a variety of pre-emption tests,¹⁶⁸ the relevant inquiry is whether the proposal presents an obstacle to the accomplishment of the federal statute's full purpose and objective.¹⁶⁹

In *MITE*, a plurality of the Court held that the major purpose of the Williams Act is to protect target shareholders.¹⁷⁰ The plurality reasoned that this protection occurs not only by providing target shareholders with adequate information about the takeover,¹⁷¹ but also by avoiding statutory favoritism of either management or the takeover bidder.¹⁷² The plurality found that three aspects of the Illinois Act—the pre-commence-

166. See *supra* note 163.

167. The pre-emption doctrine is based on the Constitution's supremacy clause, U.S. CONST. art. VI, cl. 2, which provides that state laws and regulations are subordinate to federal laws and regulations. Thus, when state and federal laws conflict, the Constitution dictates that the federal law pre-empt the state law. See *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977); see also J. NOWAK, R. ROTUNDA & J. YOUNG, *CONSTITUTIONAL LAW* 292 (2d ed. 1983).

168. The Court has held that Congress' intent to pre-empt a given state law can be inferred by one of five tests. See *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941) (discussing variety of expressions used to describe pre-emption); see also *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 153 (1982) (discussing various ways pre-emption may be inferred); *Pennsylvania v. Nelson*, 350 U.S. 497, 501 (1956) (different criteria have furnished touchstones for determination of pre-emption); *Rich v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947) (congressional intent may be evidenced in several ways); McCauliff, *Federalism and the Constitutionality of State Takeover Statutes*, 67 VA. L. REV. 295, 300 (1981) (discussing various tests for determining pre-emption); Casenote, *The Unsung Death of State Takeover Statutes: Edgar v. MITE Corp.*, 24 B.C.L. REV. 1017, 1030 (1983) (pre-emption doctrine applies in at least three contexts).

169. This was the test used by the plurality of the Court to find pre-emption of the state law in *MITE*, 457 U.S. at 631-32.

170. *Id.* at 631-33.

171. *Id.* at 634.

172. *Id.* at 633.

ment notification requirement,¹⁷³ the hearing provisions,¹⁷⁴ and the provisions allowing the Secretary of State to rule on the substantive fairness of the tender offer¹⁷⁵—tipped the balance against the bidder and thus obstructed the Williams Act's objective of protecting target shareholders.¹⁷⁶

The Illinois Act required the tender offeror to notify both the target company and the Secretary of State twenty days before the offer became effective.¹⁷⁷ The plurality found that the additional time provided under the state Act afforded incumbent management an opportunity to defeat the tender offer, perhaps to the detriment of the investors.¹⁷⁸ Accordingly, the plurality found that the pre-commencement notice provision frustrated the objective of the Williams Act.¹⁷⁹

Furthermore, under the Illinois Act, the Secretary of State could call a hearing at any time prior to the commencement of the offer, without any deadline for completing the hearing.¹⁸⁰ Moreover, the statute required the Secretary to call a hearing upon the request of investors in Illinois owning at least 10% of the outstanding shares.¹⁸¹ Because incumbent management frequently controls 10% of a corporation's outstanding shares, this provision allowed target management to combat a tender offer by delaying the commencement of the offer.¹⁸² The potential for delay favored target management at the expense of the target shareholders and upset the balance between management and bidder. In enacting the Williams Act, however, Congress sought to prevent delay tactics, recognizing that delay could seriously impede a tender offer.¹⁸³ Because the Illinois Act afforded management an advantage in resisting

173. The Illinois Act required notice to the target 20 days before the commencement of the tender offer. *Id.* at 634-35 (citing ILL. REV. STAT. ch. 121 1/2, §§ 137.54.B, 137.54.E (1979)).

174. *MITE*, 457 U.S. at 637 (citing ILL. REV. STAT. ch. 121 1/2, §§ 137.57.A-B (1979)).

175. *MITE*, 457 U.S. at 637 (citing ILL. REV. STAT. ch. 121 1/2, § 137.57.A (1979)).

176. Congress recognized that delay was a serious impediment to a tender offer and thus could be detrimental to investors' interests. See *MITE*, 457 U.S. at 637-38; *Great W. United Corp. v. Kidwell*, 577 F.2d 1256, 1277 (5th Cir. 1978), *rev'd on other grounds sub nom. Leroy v. Great W. United Corp.*, 433 U.S. 173 (1979); S. REP. NO. 550, 90th Cong., 1st Sess. 4 (1967).

177. *MITE*, 457 U.S. at 635 (citing ILL. REV. STAT. ch. 121 1/2, §§ 137.54.E, 137.54.B (1979)).

178. *MITE*, 457 U.S. at 635.

179. *Id.*

180. *MITE*, 457 U.S. at 637 (citing ILL. REV. STAT. ch. 121 1/2, § 137.57.A-B (1979)).

181. *MITE*, 457 U.S. at 637 (citing ILL. REV. STAT. ch. 121 1/2, § 137.57.A (1979)).

182. *MITE*, 457 U.S. at 637.

183. *Id.* (citing *Kidwell*, 577 F.2d at 1277; see also S. REP. NO. 550, 90th Cong., 1st Sess. 4 (1967)).

tender offers, the Act conflicted with the Williams Act objective of protecting shareholders.¹⁸⁴

Finally, the plurality found that the Williams Act pre-empted the Illinois Act to the extent that the latter statute allowed the Secretary of State to rule on the substantive fairness of the tender offer.¹⁸⁵ Although Congress intended the Williams Act to protect investors,¹⁸⁶ the state's approach offered investor protection only at the expense of investor autonomy.¹⁸⁷ Thus, the Williams Act pre-empted the Illinois Act because the state statute conflicted with the approach Congress had adopted.

Following the reasoning of *MITE*, one argument against the constitutionality of the proposed legislation is that its requirement of shareholder approval disadvantages target management, thereby interfering with the Williams Act's goal of neutrality; hence, the proposed legislation is pre-empted. This argument can be refuted, however, by distinguishing the Williams Act goal of neutrality from its actual purpose, namely, the protection of target shareholders. The Court endorsed this view in *Piper v. Chris Craft Industries, Inc.*,¹⁸⁸ stating that the "policy of evenhandedness does not go . . . to the purpose of the [Williams Act]. Neutrality is, rather, but one characteristic of legislation directed toward a different purpose—the protection of investors."¹⁸⁹ Thus, any legislation that interferes with neutrality, but does not interfere with the protection of shareholders, presents no obstacle to the Williams Act and thus is not pre-empted by the federal law.

Moreover, the proposed legislation avoids the pre-emption problems of *MITE*. First, unlike the Illinois Act, which allowed target management to use delay to resist a tender offer,¹⁹⁰ the proposal provides no weapon for either bidders or target managements; the proposal gives only target shareholders the ability to abort defensive tactics. Second, the proposal offers shareholder protection without sacrificing shareholder autonomy. By allowing target management to resist tender offers only upon shareholder authorization, the proposed legislation is consistent

184. *MITE*, 457 U.S. at 639.

185. *Id.* Under the Illinois Act, the Secretary was required to deny registration of the tender offer if he found it inequitable. *Id.* (citing ILL. REV. STAT. ch. 121 1/2, § 137.57.E (1979)).

186. *MITE*, 457 U.S. at 639 (citing H.R. REP. NO. 1711, 90th Cong., 2d Sess. 4 (1968); S. REP. NO. 550, 90th Cong., 1st Sess. 3 (1967)).

187. *MITE*, 457 U.S. at 640.

188. 430 U.S. 1 (1977).

189. *Id.* at 29.

190. *MITE*, 457 U.S. at 637.

with the intent underlying the Williams Act to allow shareholders the freedom to make their own decisions in a tender offer.

Conclusion

The proliferation of tender offers as an accepted way of expanding businesses has resulted in a comparable proliferation of defensive tactics used by target management seeking to retain corporate independence. Lacking legislative guidance or traditional judicial tests appropriate for evaluating conflicts of interest, state courts currently approach these defensive tactics with a rigidity reminiscent of the early freeze-out cases. If the fiduciary concept is to have any meaning and effect, courts cannot evaluate defensive tactics under rules and statutory provisions designed for transactions in which management is not engaged in self-dealing.

The current gap in this area of the law parallels in many respects the inchoate state of the law of freeze-out mergers in the 1970's. Left to its own devices, the Delaware Supreme Court created the *Weinberger* standards for freeze-out mergers. The *Weinberger* method implies that management can remove the taint of a conflict of interest by obtaining a fair vote from a majority of the minority shareholders. The Delaware Supreme Court, and other courts, similarly may resolve the problem of defensive tactics. The courts' task could be eased considerably, the result would be clearer, and the process would be better if the regulation came from the state legislatures rather than the state courts. This Commentary proposes that the state legislatures enact an amendment to the Model Business Corporation Act that would establish a method similar to that in *Weinberger* for approval of target management defensive tactics.

The proposed legislation, which requires shareholder approval for any defensive tactic, is an attempt to accommodate many competing interests. Foremost are the conflicting interests of management and shareholders who are the targets of an actual or a potential tender offer. The decision whether or not to sell in response to a tender offer is a right of the shareholder as an investor and should not be abridged absent some consensual process. Because of the inherent conflict of interest, the decision to defend against a tender offer should not rest solely with management. Management, however, by state statute is delegated much of the initiative in areas of corporate governance, the arena in which most defensive tactics occur. Although a prior ban on management's entry into this area may be a solution, it is not the most desirable because its overinclusiveness would ban certain nontainted corporate actions. The best approach, therefore, is to allow defensive tactics only upon shareholder approval.